MISCELLANEOUS TAX BILLS II

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 224, S. 401, S. 616, S. 687, S. 736, S. 945, and S. 1514

SEPTEMBER 17, 1979

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MISCELLANEOUS TAX BILLS II

MONDAY, SEPTEMBER 17, 1979

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., chairman of the subcommittee, presiding.

Present: Senators Byrd, Talmadge, Dole, Packwood, and Chafee.

[The press release announcing this hearing and the bills S. 224, S. 401, S. 616, S. 687, S. 736, S. 945, and S. 1514 follow:]

[Press release]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr. (I-Va), Chairman of the Subcommittee on Taxation and Debt Management announced today that a hearing will be held on September 17, 1979, on miscellaneous tax bills.

The hearing will begin at 9:30 A.M. in Room 2221 of the Dirksen Senate Office Building.

The following pieces of legislation will be considered:

S. 224, sponsored by Senators Hatch, Dole, Domenici, Goldwater, Hayakawa, Helms, Schmitt, Stevens, Thurmond, Tower, and Young, would prohibit permanently the issuance of IRS regulations on the taxation of fringe benefits. The measure involves no revenue loss since it would continue current law. However, revenue estimates showing revenue gains derived from implementation of the proposed Internal Revenue Service regulations dealing with fringe benefits will be furnished on the day of the hearing. The bill would benefit taxpayers affected by the proposed fringe benefit regulations of the Internal Revenue Service.

S. 616, sponsored by Senators Dole and Thurmond, would amend the Internal Revenue Code to permit an income tax, an estate tax, and a gift tax deduction for contributions to the construction or maintenance of buildings housing fraternal organizations. Revenue estimates on this measure will be furnished on the day of the hearing. The measure will benefit fraternal organizations with building programs and taxpayers who make contributions to these organizations for building or maintaining facilities housing the organization.

S. 687, sponsored by Senators Chafee and Pell, which amends the Rhode Island Indian Claims Settlement Act to provide an exemption from taxes with respect to the settlement lands and amounts received by a state-controlled corporation in connection with litigation dealing with Indian land claims and to provide a deferral of capital gains with respect to the sale of settlement lands. Revenue estimates on this measure will be furnished at the time of the hearing. The measure will benefit parties to land settlements negotiated in connection with litigation dealing with Indian land claims.

S. 1514, sponsored by Senators Byrd (Va.) and Warner, which would amend the Internal Revenue Code with respect to the tax-exempt status of interest on certain governmental obligations the proceeds of which are to be used to provide solid waste disposal facilities. The bill would involve a revenue loss in fiscal year 1980 of $2 million, 1981 of $13 million, 1982 of $39 million, and 1983 of $81 million. The bill

would benefit the Southeastern Public Services Authority of Virginia and other governmental units involved in the collection of solid waste materials and the conversion of such materials into energy.

It is estimated that as many as 40 projects of this nature may exist throughout the country.

S. 736, sponsored by Senators Dole, DeConcini, and Matsunaga, which would amend the Internal Revenue Code to clarify the standards used in determining whether individuals are not employees for purposes of employment taxes. Revenue estimates on the measure will be furnished at the time of the hearing. The measure is designed to clarify the tax status of individuals as independent contractors and has broad application to all taxpayers considered to be independent contractors.

S. 401, sponsored by Senator Moynihan, for the relief of the Manhattan Bowery Corporation, of New York, New York, relieving the corporation of liability for repayment of Social Security taxes erroneously refunded to its employees. Revenue estimates on the measure will be furnished at the time of the hearing. The bill will benefit the Manhattan Bowery Corporation.

S. 945, sponsored by Senators Mathias, Chafee, and Boren, which would provide that annuity contracts bought by the faculty and staff of the Uniform Services University of health Sciences, Bethesda, Maryland, be treated as if the University were a state-funded school or charitable organization and therefore entitled to the benefits of Section 403(b) of the Internal Revenue Code. Revenue estimates on this measure will be furnished at the time of the hearing. The measure will benefit the Uniform Services University of Health Sciences.

Witnesses who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C., 20510 by no later than the close of business on September 13, 1979.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witnesses is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Not more than ten minutes will be allowed for oral presentation.

(5) Witnesses are not to read their written statements to the Subcommittee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

Written testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies by October 12, 1979, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

96TH CONGRESS
1ST SESSION

S. 224

To prohibit permanently the issuance of regulations on the taxation of fringe benefits.

IN THE SENATE OF THE UNITED STATES

JANUARY 25 (legislative day, JANUARY 15), 1979

Mr. HATCH (for himself, and Mr. STEVENS, Mr. YOUNG, Mr. TOWER, Mr. DOMENICI, Mr. HAYAKAWA, Mr. HELMS, Mr. THURMOND, Mr. GOLDWATER, Mr. SCHMITT and Mr. DOLE) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To prohibit permanently the issuance of regulations on the taxation of fringe benefits.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That subsection (a) of section 1 of the Act entitled "An Act
4 to prohibit the issuance of regulations on the taxation of
5 fringe benefits, and for other purposes", approved October 7,
6 1978 (Public Law 95-427; 92 Stat. 996) is amended to read
7 as follows:

1 "(a) IN GENERAL.—No fringe benefit regulation shall
2 be issued in proposed or final form after April 30, 1979.".

96TH CONGRESS
1ST SESSION

S. 401

For the relief of the Manhattan Bowery Corporation, of New York, New York.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 8 (legislative day, JANUARY 15), 1979

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

For the relief of the Manhattan Bowery Corporation, of New York, New York.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a)(1) notwithstanding any other provision of law, any
4 waiver certificate filed by the Manhattan Bowery Corpora-
5 tion of New York, New York (hereinafter in this section re-
6 ferred to as the "Corporation"), under section 3121 (k)(1) of
7 the Internal Revenue Code of 1954 (relating to waiver of
8 exemption from social security taxes by certain organiza-
9 tions) shall be deemed not to be effective, for purposes of the

1 taxes imposed by section 3101 of such Code, with respect to
2 any wages—
3 (A) paid by the Corporation to any employee
4 thereof after December 31, 1972 and prior to April 1,
5 1975, if the Corporation furnishes to the Secretary of
6 the Treasury evidence reasonably satisfactory to him
7 that the Corporation has refunded, prior to February 1,
8 1977, to such employee (or to his survivors or estate)
9 the full amount of the taxes imposed by section 3101
10 of such Code on such wages, or
11 (B) paid after March 31, 1975 and prior to July
12 1, 1977 by the Corporation to an individual as an em-
13 ployee of the Corporation, if the Corporation furnishes
14 to the Secretary of the Treasury evidence reasonably
15 satisfactory to him that (i) such individual was not an
16 employee of the Corporation on June 30, 1978, and (ii)
17 no amount of the taxes imposed by section 3101 of
18 such Code on such wages were withheld by the Corpo-
19 ration from such wages.
20 (2)(A) The provisions of paragraph (1)—
21 (i) insofar as they relate to wages described in
22 subparagraph (A) of such paragraph, shall not become
23 effective unless, prior to the close of the one-year
24 period which begins on the date of enactment of this
25 Act, the Corporation furnishes to the Secretary of the

1 Treasury the evidence referred to in such subpara-
2 graph; or
3 (ii) insofar as they relate to wages described in
4 subparagraph (B) of such paragraph, shall not become
5 effective unless, prior to the one-year period which
6 begins on the date of enactment of this Act, the Corpo-
7 ration furnishes to the Secretary of the Treasury the
8 evidence referred to in such subparagraph.
9 (B) Whenever the provisions of paragraph (1) become
10 effective with respect to any wages paid by the Corporation
11 to an employee thereof, no taxes imposed on such wages by
12 section 3101 of the Internal Revenue Code of 1954 shall be
13 payable, and no interest or penalty with respect to the impo-
14 sition of taxes by such section on such wages (or with respect
15 to the imposition of taxes by such section or section 3111 of
16 such Code on any wages paid by the Corporation prior to
17 July 1, 1978) shall be imposed or collected.
18 (b)(1) In the administration of titles II and XVIII of the
19 Social Security Act, the wages, paid to an individual, to
20 which the provisions of subsection (a) become effective shall
21 (except as otherwise is provided in paragraphs (2) and (3)) be
22 deemed not to constitute "wages" (as defined in section 209
23 of such Act) for purposes of determining—
24 (A) entitlement to or amount of any insurance
25 benefit payable to such individual or any other person

1 on the basis of the wages and self-employment income
2 of such individual, or
3 (B) entitlement of such individual to benefits
4 under title XVIII of such Act or entitlement of any
5 other person to such benefits on the basis of the wages
6 and self-employment income of such individual.
7 (2) The provisions of paragraph (1) shall not be applica-
8 ble in the case of any individual described therein (or to any
9 other person claiming a benefit referred to in paragraph (1)
10 on the basis of the wages and self-employment income of
11 such individual) if, on or before the date of enactment of this
12 Act, such individual dies or attains age 62, or if on such date
13 such individual is under a disability (as defined in section
14 216(i) of the Social Security Act) which began prior to such
15 date.
16 (3)(A) The provisions of paragraph (1) shall not be appli-
17 cable to any individual described therein (or to any other
18 person claiming a benefit referred to in paragraph (1) on the
19 basis of the wages and self-employment income of such indi-
20 vidual), if such individual enters into an arrangement with
21 the Secretary of the Treasury for paying into the Treasury
22 an amount equal to the taxes imposed by section 3101 of the
23 Internal Revenue Code of 1954 on the wages, paid to such
24 individual, with respect to which the provisions of subsection
25 (a) have become effective.

1 (B) The Secretary of the Treasury shall by regulations
2 prescribe the manner in which such an arrangement for pay-
3 ment by an individual shall be made. Any such arrangement
4 shall afford the individual a reasonable time in which such
5 payment shall be made and the amount and time of the in-
6 stallments which will be made toward such repayment, and
7 shall contain appropriate conditions to protect the interests of
8 the United States and to assure equitable treatment to the
9 individual in the event that the individual fails fully to comply
10 with the arrangement.

11 (C) The Secretary of the Treasury and the Secretary of
12 Health, Education, and Welfare shall cooperate in assuring
13 that, insofar as is practicable, each individual who is eligible
14 to enter an arrangement under this paragraph will be notified
15 of that fact and given an adequate opportunity to enter into
16 such an arrangement.

17 (c) Nothing in this Act shall be construed to relieve the
18 Corporation of any liability for the payment of the taxes im-
19 posed by section 3111 of the Internal Revenue Code of 1954
20 with respect to any wages paid by it to any individual for any
21 period.

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96TH CONGRESS
1ST SESSION

S. 616

To amend the Internal Revenue Code of 1954 to allow a deduction for contributions for the construction or maintenance of buildings housing fraternal organizations.

IN THE SENATE OF THE UNITED STATES

MARCH 12 (legislative day, FEBRUARY 22), 1979

Mr. DOLE (for himself and Mr. THURMOND) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to allow a deduction for contributions for the construction or maintenance of buildings housing fraternal organizations.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 170(c)(4) of the Internal Revenue Code of
4 1954 (relating to charitable contributions) is amended by
5 striking out "or for the prevention of cruelty to children or
6 animals" and inserting in lieu thereof "for the prevention of
7 cruelty to children or animals, or, in the case of a contribu-
8 tion or gift to an organization described in section 501(c)(10),

II—E

1 for the construction or maintenance of a building the principal
2 purpose of which is to house such organization".
3 (b) Section 2055(a)(3) of the Internal Revenue Code of
4 1954 (relating to estate tax charitable contribution deduc-
5 tions) is amended by striking out "or for the prevention of
6 cruelty to children or animals" and inserting in lieu thereof
7 "for the prevention of cruelty to children or animals, or, in
8 the case of a contribution or gift to an organization described
9 in section 501(c)(10) for the construction or maintenance of a
10 building the principal purpose of which is to house such
11 organization".
12 (c) Section 2522(a)(3) of the Internal Revenue Code of
13 1954 (relating to gift tax charitable contribution deductions)
14 is amended by striking out "art and the prevention of cruelty
15 to children or animals" and inserting in lieu thereof "art, the
16 prevention of cruelty to children or animals, and, in the case
17 of a contribution or gift to an organization described in sec-
18 tion 501(c)(10), the construction or maintenance of a building
19 the principal purpose of which is to house such organization".
20 (d) The amendments made by this Act shall be effective
21 with respect to gifts or contributions made after the date of
22 enactment of this Act.

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96TH CONGRESS
1ST SESSION

S. 687

To amend the Rhode Island Indian Claims Settlement Act to provide an exemption from taxes with respect to the settlement lands and amounts received by the State Corporation, and to provide a deferral of capital gains with respect to the sale of settlement lands.

IN THE SENATE OF THE UNITED STATES

MARCH 15 (legislative day, FEBRUARY 22), 1979

Mr. CHAFEE (for himself and Mr. PELL) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Rhode Island Indian Claims Settlement Act to provide an exemption from taxes with respect to the settlement lands and amounts received by the State Corporation, and to provide a deferral of capital gains with respect to the sale of settlement lands.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) the Rhode Island Indian Claims Settlement Act
4 (Public Law 95-395) is amended by adding at the end there-
5 of the following new sections:

II—E

1 "EXEMPTION FROM TAXATION

2 "SEC. . (a) Except as otherwise provided in subsec-
3 tions (b) and (c), the settlement lands and any moneys re-
4 ceived by the State Corporation from the Fund shall not be
5 subject to any form of Federal, State, or local taxation.

6 "(b) The exemption provided in subsection (a) shall not
7 apply to any income-producing activities occurring on the
8 settlement lands.

9 "(c) Nothing in this Act shall prevent the imposition of
10 payments in lieu of taxes on the State Corporation for serv-
11 ices provided in connection with the settlement lands.

12 "(d) The exemption provided in subsection (a) as it re-
13 lates to amounts received by the State Corporation from the
14 Fund shall not apply if any of such amounts are used for, or
15 diverted to, any purpose other than—

16 "(1) the purposes authorized under this Act; or

17 "(2) investment (but only to the extent that the
18 invested portion of such amounts is not currently
19 needed for the purposes otherwise authorized by this
20 Act) in—

21 "(A) public debt securities of the United
22 States,

23 "(B) obligations of a State or local govern-
24 ment which are not in default as to principal or
25 interest, or

1 "(C) time or demand deposits in a bank (as
2 defined in section 581 of the Internal Revenue
3 Code of 1954) or an insured credit union (within
4 the meaning of section 101(6) of the Federal
5 Credit Union Act (12 U.S.C. 1752(6)) located in
6 the United States.

7 "DEFERRAL OF CAPITAL GAINS

8 "SEC. . For purposes of subtitle A of the Internal
9 Revenue Code of 1954, any sale or disposition of private
10 settlement lands pursuant to the terms and conditions of the
11 Settlement Agreement shall be treated as an involuntary
12 conversion within the meaning of section 1033 of the Inter-
13 nal Revenue Code of 1954.".

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96TH CONGRESS
1ST SESSION

S. 736

To amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are not employees for purposes of the employment taxes.

IN THE SENATE OF THE UNITED STATES

MARCH 22 (legislative day, FEBRUARY 22), 1979

Mr. DOLE introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are not employees for purposes of the employment taxes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Employment Tax Act of
5 1979".
6 **SEC. 2. STANDARDS.**
7 (a) IN GENERAL.—Chapter 25 of the Internal Revenue
8 Code of 1954 (relating to general provisions relating to the

1 employment taxes) is amended by adding at the end thereof
2 the following new section:
3 "SEC. 3508. ALTERNATIVE STANDARDS FOR DETERMINING
4 WHETHER INDIVIDUALS ARE NOT EMPLOYEES.
5 "(a) GENERAL RULE.—For purposes of this subtitle
6 other than chapter 22 and for purposes of chapter 2, and
7 notwithstanding any other provision of chapters 21, 23, and
8 24 of this subtitle, if all of the requirements of subsection (b)
9 are met with respect to service performed by any indi-
10 vidual—
11 "(1) such service shall be treated as being per-
12 formed by an individual who is not an employee, and
13 "(2) the person for whom such service is per-
14 formed shall not be treated as an employer with re-
15 spect to such service.
16 "(b) REQUIREMENTS.—For purposes of subsection (a),
17 the requirements of this subsection are met with respect to
18 service performed by any individual if—
19 "(1) CONTROL OF HOURS WORKED.—The indi-
20 vidual controls the aggregate number of hours actually
21 worked and substantially all of the scheduling of the
22 hours worked.
23 "(2) PLACE OF BUSINESS.—The individual does
24 not maintain a principal place of business, or, if he
25 does so, his principal place of business is not provided

1 by the person for whom such service is performed, or,
2 if it is so provided, the individual pays such person
3 rent therefor. For purposes of this paragraph, the indi-
4 vidual shall be deemed not to have a principal place of
5 business if he does not perform substantially all the
6 service at a single fixed location.
7 "(3) INVESTMENT OR INCOME FLUCTUATION.—
8 "(A) The individual has a substantial invest-
9 ment in assets used in connection with the per-
10 formance of the service, or
11 "(B) The individual risks income fluctuations
12 because his remuneration with respect to such
13 service is directly related to sales or other output
14 rather than to the number of hours actually
15 worked.
16 "(4) WRITTEN CONTRACT AND NOTICE OF TAX
17 RESPONSIBILITIES.—
18 "(A) The individual performs the service pur-
19 suant to a written contract between the individual
20 and the person for whom such service is per-
21 formed—
22 "(i) which was entered into before the
23 performance of the service, and
24 "(ii) which provides that the individual
25 will not be treated as an employee with re-

1 spect to such service for purposes of the
2 Federal Insurance Contributions Act, the
3 Social Security Act, the Federal Unemploy-
4 ment Tax Act, and income tax withholding
5 at source; and
6 "(B) The individual is provided written
7 notice, in such contract or at the time such con-
8 tract is executed, of his responsibility with respect
9 to the payment of self-employment and Federal
10 income taxes.
11 "(5) FILING OF REQUIRED RETURNS.—The
12 person for whom such service is performed files any in-
13 formation returns required in respect of such service
14 under section 6041(a).
15 "(c) SPECIAL RULES.—
16 "(1) SECTION NOT TO APPLY TO CERTAIN INDI-
17 VIDUALS FOR PURPOSES OF SOCIAL SECURITY
18 TAXES.—For purposes of chapters 2 and 21, this sec-
19 tion shall not apply to an individual described in sec-
20 tion 3121(d)(3) (relating to certain agent-drivers, com-
21 mission-drivers, full-time life insurance salesmen, home
22 workers, and traveling or city salesmen).
23 "(2) SPECIAL RULE FOR CONTRACTS ENTERED
24 INTO BEFORE 1981.—With respect to contracts en-
25 tered into before January 1, 1981, subparagraph (b)(4)

1 of this section shall be deemed to be satisfied if such
2 contract clearly indicates that the individual is not an
3 employee (either by specifying that the individual is an
4 independent contractor or otherwise), provided that the
5 notice required by subparagraph (b)(4)(B) is given
6 before January 1, 1981.".

7 (b) CLERICAL AMENDMENT.—The table of sections for
8 such chapter 25 is amended by adding at the end thereof the
9 following new item:

"Sec. 3508. Alternative standards for determining whether individuals are not employees.".

10 **SEC. 3. SOCIAL SECURITY COVERAGE.**

11 Section 210(a) of the Social Security Act is amended by
12 striking out "or" at the end of paragraph (19), by striking out
13 the period at the end of paragraph (20) and by inserting in
14 lieu thereof "; or", and by adding after paragraph (20) the
15 following new paragraph:

16 "(21) Service which, under section 3508 of the
17 Internal Revenue Code of 1954, is treated as being
18 performed by an individual who is not an employee.".

19 **SEC. 4. EFFECTIVE DATE.**

20 The amendments made by this Act shall apply to serv-
21 ice performed after December 31, 1979.

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II

96TH CONGRESS
1ST SESSION

S. 945

To provide that annuity contracts purchased by the Uniformed Services University of the Health Sciences shall be entitled to the benefits of section 403(b) of the Internal Revenue Code of 1954.

IN THE SENATE OF THE UNITED STATES

APRIL 10 (legislative day, APRIL 9), 1979

Mr. MATHIAS (for himself and Mr. BOREN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To provide that annuity contracts purchased by the Uniformed Services University of the Health Sciences shall be entitled to the benefits of section 403(b) of the Internal Revenue Code of 1954.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That an annuity contract purchased by the Uniformed Serv-
4 ices University of the Health Sciences for any employee who
5 is a member of the civilian faculty or staff of such university
6 shall, for purposes of section 403(b) of the Internal Revenue
7 Code of 1954, be treated as an annuity contract purchased

1 for an employee by an employer described in section
2 501(c)(3) of such Code which is exempt from tax under sec-
3 tion 501(a) of such Code.

4 SEC. 2. The first section of this Act shall apply to serv-
5 ice after December 31, 1977, in taxable years ending after
6 such date.

O

II

96TH CONGRESS
1ST SESSION

S. 1514

To amend the Internal Revenue Code of 1954 with respect to interest on certain governmental obligations the proceeds of which are to be used to provide solid waste disposal facilities.

IN THE SENATE OF THE UNITED STATES

JULY 13 (legislative day, JUNE 21), 1979

Mr. HARRY F. BYRD, JR. (for himself and Mr. WARNER) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 with respect to interest on certain governmental obligations the proceeds of which are to be used to provide solid waste disposal facilities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 103 of the Internal Revenue Code of 1954 (re-
4 lating to interest on certain governmental obligations) is
5 amended—
6 (1) by adding at the end of paragraph (4) of sub-
7 section (b) the following: "For purposes of subpara-

1 graph (E) the term 'solid waste disposal facility' in-
2 cludes any facility which has the function of recovering
3 material from solid wastes and any facility, operated by
4 or on behalf of the governmental unit, which has the
5 function of producing gas, heat, or energy directly or
6 indirectly from the solid waste disposal process and
7 which is located at the same place as, or adjacent to, a
8 solid waste disposal facility.",
9 (2) by redesignating subsection (g) as (h), and
10 (3) by inserting immediately after subsection (f)
11 the following new subsection:
12 "(g) FEDERAL USE OF SOLID WASTE DISPOSAL
13 FACILITIES.—An industrial development bond, substantially
14 all of the proceeds of which are to be used to provide solid
15 waste disposal facilities (within the meaning of subsection
16 (b)(4)(E)), shall not be treated as an obligation not described
17 in subsection (a)(1) solely—
18 "(1) because a facility or any materials, gas, heat,
19 or energy that is recovered or results from the disposal
20 process is to be used by, or for the benefit of, an
21 agency or instrumentality of the United States Govern-
22 ment, or
23 "(2) because the payment of the principal or inter-
24 est on such obligation is to be derived, in whole or in

1 part, from payments by an agency or instrumentality of
2 the United States Government in respect of such use."
3 SEC. 2. The amendments made by the first section of
4 this Act shall apply with respect to obligations issued after
5 June 30, 1979.

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Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

The Subcommittee on Taxation and Debt Management will consider several miscellaneous tax bills this morning.

The bills to be considered are S. 224, introduced by the Senator from Utah, Mr. Hatch; S. 401, introduced by the Senator from New York, Mr. Moynihan; S. 1616, introduced by the Senator from Kansas, Mr. Dole; S. 687, introduced by the Senator from Rhode Island, Mr. Chafee; S. 736, introduced by the Senator from Kansas, Mr. Dole; S. 945, introduced by the Senator from Maryland, Mr. Mathias; and S. 1514, introduced by the two Senators from Virginia.

A pamphlet, prepared by the Joint Tax Committee providing greater detail on each of these measures has been supplied to the committee and shall be included as a part of the record of the hearings.

[The material referred to follows:]

INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on September 17, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a description of each bill, setting forth present law, the issues involved, an explanation of the provisions, the effective dates, and the estimated revenue effects. Also included is the position of the Treasury Department. The summary and description of the bills are in the numerical order of the bills listed for the hearing.

The bills described in the pamphlet are:

(1) S. 224 (relating to taxation of fringe benefits);

(2) S. 401 (for the relief of the Manhattan Bowery Corporation);

(3) S. 616 (relating to deductions for contributions for the construction or maintenance of fraternal organization buildings);

(4) S. 687 (relating to the tax treatment under the Rhode Island Indian Claims Settlement Act);

(5) S. 736 (relating to the classification of workers as employees or independent contractors);

(6) S. 945 (relating to annuity contracts purchased by the Uniformed Services University of the Health Sciences); and

(7) S. 1514 (relating to tax treatment of interest on certain governmental obligations issued for facilities that convert solid waste into energy).

I. SUMMARY

1. S. 224—Senators Hatch, Stevens, Young, Tower, Domenici, Hayakawa, Helms, Thurmond, Goldwater, Schmitt, and Dole

Taxation of Fringe Benefits

Under present law, gross income generally includes compensation for services paid in a form other than cash. However, under administrative practice, some employee fringe benefits have not been considered to be includible in an employee's gross income.

In 1978, Public Law 95-427 was enacted to prohibit the issuance of any regulation in final form on or after May 1, 1978, and before January 1, 1980, providing for the inclusion of any fringe benefit in gross income under section 61 of the Code.

The bill provides that no fringe benefit regulation shall be issued in proposed or final form after April 30, 1979.

2. S. 401—Senator Moynihan

Termination of Waiver of Exemption from Social Security Taxes Filed by the Manhattan Bowery Corporation

Under present law, services performed for a nonprofit religious, charitable, educational, or other organization exempt from income tax are not covered by social security unless the organization waives its exemption from social security coverage. In general, the bill would terminate retroactively a waiver of exemption from social security coverage filed by the Manhattan Bowery Corporation of New York, New York.

3. S. 616—Senators Dole and Thurmond

Income, Gift, and Estate Tax Deduction for Contributions for the Construction or Maintenance of Buildings Housing Fraternal Organizations

The bill would allow a deduction for Federal income, gift, and estate tax purposes for a contribution or gift to a tax-exempt fraternal organization for the construction or maintenance of a building which is principally used to house the organization.

4. S. 687—Senators Chafee and Pell

Tax Treatment Under Rhode Island Indian Claims Settlement Act

The bill would provide that the lands received by the public corporation established pursuant to the Rhode Island Indian Claims Settlement Act would generally be exempt from Federal, State, or local taxation, except for taxes on income-producing activities and payments for services made in lieu of taxes. The bill would also provide that private owners selling land to be conveyed to the corporation pursuant to the settlement could treat the sales as involuntary conversions, thus allowing deferral of tax on the gain if sale proceeds are reinvested.

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5. S. 736—Senator Dole

"Employment Tax Act of 1979"

Under present law, the classification of particular workers as employees or independent contractors for Federal income and employment tax purposes generally is determined under common law rules. Under the common law, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is to be accomplished," their relationship is one of employer and employee.

The bill would provide a statutory "safe harbor" test which, if met, would result in an individual being classified as an independent contractor.

6. S. 945—Senators Mathias and Boren

Tax Treatment of Annuities Purchased for Employees of the Uniformed Services University of the Health Sciences

Present law provides that, if an annuity is purchased for an employee by an exempt organization described in section 501(c)(3) of the Code or by a public school system, the employer's contributions for the annuity contract are excludable, within certain limitations, from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract.

The bill would extend the same rule to qualifying annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences, which was established by the Congress under the Department of Defense to train medical students for the uniformed services.

7. S. 1514—Senators Byrd (Va.) and Warner

Tax Treatment of Interest on Certain Governmental Obligations Issued for Facilities That Convert Solid Waste Into Energy

The bill would permit the issuance of tax-exempt industrial development bonds for facilities which have the function of recovering material from solid waste and any facilities, operated by or on behalf of a government, which have the function of producing gas, heat, or energy, directly or indirectly, from a solid waste disposal process and which are located at the same place as, or adjacent to, a solid waste disposal facility. In addition, the bill would permit the issuance of tax-exempt industrial development bonds for solid waste disposal facilities even though the facility, or any material, gas, heat, or energy that is recovered or results from the disposal process, is to be used by, or for the benefit of, an agency or instrumentality of the United States Government. Further, obligations for such facilities are to qualify for tax-exempt treatment, although the payment of principal or interest on the bonds is to be derived, in whole or in part, from payments made by an agency or instrumentality of the United Sttaes Government.

II. DESCRIPTION OF BILLS

1. S. 224—Senators Hatch, Stevens, Young, Tower, Domenici, Hayakawa, Helms, Thurmond, Goldwater, Schmitt, and Dole

Taxation of Employee Fringe Benefits

Present law

Section 61 of the Internal Revenue Code defines gross income as including "all income from whatever source derived" and specifies that it includes "compensation for services". The regulations (§ 1.61-2 (a)(1)) provide that income includes compensation for services paid for other than in money. Further, the Supreme Court has stated that section 61 "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation whatever the form or mode by which it is effected."[1] In actual practice, however, the "economic benefit" test has not been rigidly followed. Thus, where compensation is paid in some form other than cash, the issue as to taxability has been resolved by statutes, regulations, and administrative rulings which take account of several different factors.

Some fringe benefits, such as the provision of health insurance by an employer for its employees, are expressly excluded from gross income by the Internal Revenue Code; others are excluded by legislation outside the Code; and yet other exclusions are based on judicial authority or on administrative practice. For example, some fringe benefits have been excluded under administrative practice on the basis of a *de minimis* principle, i.e, accounting for the benefit would be unreasonable or administratively impractical. Other items are excluded due to a combination of valuation difficulties and widely held perceptions that the items do not constitute income.

In 1975, the Treasury Department issued a discussion draft of proposed regulations[2] which contained a number of rules for determining whether various fringe benefits constitute taxable compensation. Under the principles contained in the discussion draft, some employee fringe benefits which, as a matter of prior administrative practice, had not been considered to be taxable compensation would have been treated as subject to tax. Other benefits which might be viewed as taxable compensation would not have been taxed under the discussion draft's proposed rules. The discussion draft was withdrawn by the Treasury Department on December 28, 1976.[3] Thus, the question of whether, and what, employee fringe benefits result in taxable income to employees generally continues to depend on the facts and circumstances in each individual case.

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[1] *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945).
[2] 40 Fed. Reg. 41118 (Sept. 5, 1975).
[3] 41 Fed. Reg. 56334 (Dec. 28, 1976).

In 1978, Public Law 95–427 was enacted to prohibit the Treasury Department from issuing final regulations, under section 61 of the Code, which would govern the income tax treatment of fringe benefits prior to 1980. The Act further provided that no regulations relating to the treatment of fringe benefits under section 61 were to be proposed which would be effective prior to 1980.[1]

Issues

One issue is whether the Treasury Department should be prohibited from issuing final regulations under section 61 of the Code relating to the income tax treatment of fringe benefits. A second issue is whether any prohibition should be for a definite or indefinite period of time. A third issue is whether the prohibition should extend to the issuance of proposed regulations or only to retroactive treatment under regulations proposed during the period of any prohibition but finalized after the expiration of such period.

Explanation of the bill

The bill would prohibit the Treasury Department from issuing final or proposed regulations after April 30, 1979, relating to the income tax treatment of fringe benefits under section 61 of the Code.

Effective date

The bill would be effective upon enactment.

Revenue effect

This bill would continue present administrative practice and thus would have no effect on budget receipts.

Departmental position

The Treasury Department opposes the bill.

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[1] On September 5, 1979, the Senate approved an amendment to the Treasury and Postal Service appropriations bill for fiscal 1980 (H.R. 4393) relating to fringe benefits. The amendment provides that none of the funds appropriated for fiscal year 1980 (through September 30, 1980) are to be used to issue or administer regulations providing for the inclusion of any fringe benefit in gross income by reason of section 61 of the Internal Revenue Code of 1954 unless such fringe benefit was so included as of July 1, 1978. As amended, the bill, H.R. 4393, was passed by the Senate on September 6, 1979.

On September 12, 1979, the House Committee on Ways and Means ordered H.R. 5224 reported. As amended by the committee, this bill would extend the prohibition on the issuance of fringe benefit regulations, under Public Law 95–427, until June 1, 1981.

2. S. 401—Senator Moynihan

Termination of Waiver of Exemption from Social Security Taxes Filed by the Manhattan Bowery Corporation

Present law

Under present law, services performed for a nonprofit religious, charitable, educational, or other organization exempt from income tax under section 501(a) of the Code as an organization described in section 501(c)(3) of the Code are not covered by social security. However, an organization may waive its exemption from employment taxes by filing a waiver certificate (Form SS–15) with the Internal Revenue Service certifying that it desires to have social security coverage extended to the services performed by its employees (Code secs. 3121(b)(8) and 3121(k)(1)).

A waiver of exemption from social security coverage (provided by section 3121(k)(1) of the Code) may be terminated if the organization which has waived its exemption gives two years' advance notice in writing (Code sec. 3121(k)(1)(D)). However, an organization may not terminate its waiver of exemption in this manner unless it has had a waiver in effect for a period of at least 8 years.

Background

The Manhattan Bowery Corporation, a tax-exempt organization, was incorporated under the laws of the State of New York on October 27, 1976. Since its inception, the Corporation has been withholding social security taxes from its employees' wages and has been paying these taxes, along with the employer's share of social security taxes, to the Internal Revenue Service.

In 1974, the Corporation became concerned that it might not have filed a waiver certificate (Form SS–15) waiving its exemption from social security coverage. Accordingly, the Corporation asked the IRS to waive the statutory requirements with respect to the filing of a certificate for waiver of exemption and to credit present and former employees' accounts for all quarters for which social security taxes had been paid. The IRS then informed the Corporation that the Social Security Administration would only adjust or revise earnings records for a limited period of time (i.e., no more than 3 years, 3 months and 15 days preceding the receipt of a notice of error) and that an SS–15 could be filed with an effective date 5 years subsequent to the date of filing The IRS also pointed out that all present and former empoyees of the Corporation would be entitled to make an election as to whether or not they would concur with the filing of an SS–15 (that is, whether or not they wanted social security coverage). These employees who elected not to concur would be entitled to a refund of social security taxes previously withheld, subject to a three-year statute of limitations on the period for which a refund could be granted. Likewise, the Corporation

would be entitled to a refund for the employer's share of social security taxes. Furthermore, those employees who received refunds of social security taxes previously withheld also could elect not to have social security taxes withheld from future wages, thereby foregoing the benefits of social security coverage.

On March 31, 1975, the Corporation filed a Form SS-15 with an effective date of April 1, 1970. Many of the Corporation's current and former employees elected to receive refunds of previously paid social security taxes and some of the Corporation's current employees elected to forego social security coverage for future years.

Between March 31, 1975, when the Form SS-15 was filed, and June 30, 1977, the Corporation did not withhold the employees' portion of social security taxes from those employees who elected not to be covered by social security nor did it contribute the employer's portion of social security taxes with respect to wages paid to those employees.

In March 1977, the Corporation found out that it had, in fact, previously filed a Form SS-15, with an effective date of October 1967. The IRS, therefore, reassessed the social security taxes which had been refunded (except those for the years 1971 and 1972) and demanded repayment of those taxes, along with interest and penalties, as of August 2, 1977. The IRS also assessed the Corporation for social security taxes not collected between April 1, 1975 and June 30, 1977.

The IRS has filed a lien against the Corporation and has informed the Corporation that in the event it is unable to collect the amount of social security taxes due, it may assess a penalty of 100 percent of the uncollected taxes against the officers and directors of the Corporation.

Issue

The issue is whether the Manhattan Bowery Corporation should be allowed to terminate retroactively its waiver of exemption from social security coverage.

Explanation of the bill

Subject to certain conditions, the bill would terminate retroactively the certificate for waiver of exemption from social security coverage filed by the Manhattan Bowery Corporation.

Under the bill, the waiver of exemption of the Manhattan Rowery Corporation would be deemed not to be effective, for purposes of the portion of social security taxes imposed upon an employee (Code sec. 3101), with respect to wages paid by the Corporation to an employee after December 31, 1972, and prior to April 1, 1975, if the Corporation furnishes to the Secretary of the Treasury evidence that it has refunded, prior to February 1, 1977, to such employee (or to his survivors or estate) the full amount of the employee's portion of social security taxes imposed on such wages. In addition, the waiver would be deemed not to be effective, for purposes of the portion of social security taxes imposed upon an employee, with respect to wages paid by the Corporation to an individual as an employee after March 31, 1975, and prior to July 1, 1977, if the Corporation furnishes to the Secretary evidence that such individual was not an employee of the Corporation on June 30, 1978, and that no amount of the employee's portion of social security taxes on such wages were withheld by the Corporation.

Once the provisions of the bill become effective with respect to any wages paid by the Corporation to an employee, none of the taxes imposed upon those wages by section 3101 of the Code (employee's portion of social security taxes) will be payable. In addition, no interest or penalty with respect to the imposition of taxes by sections 3101 or 3111 (employer's portion of social security taxes) of the Code on any wages paid by the Corporation prior to July 1, 1978, will be imposed or collected.

The bill provides that, in the administration of titles II (Federal Old-Age, Survivors, and Disability Insurance Benefits) and XVIII (Health Insurance for the Aged and Disabled) of the Social Security Act, wages to which the bill applies generally will be deemed not to constitute wages for purposes of determining entitlement to, or amount of, any insurance benefit payable on the basis of wages and self-employment income, or entitlement to benefits under title XVIII of the Social Security Act on the basis of wages and self-employment income. This provision, however, will not apply in the case of an individual (or to a person claiming a benefit on the basis of the wages and self-employment income of the individual) who, on or before the date of enactment, (1) dies or attains age 62; (2) is under a disability which began prior to the date of enactment; or (3) enters into an arrangement with the Secretary of the Treasury for paying into the Treasury an amount equal to the employee's portion of social security taxes on the wages, paid to the individual, with respect to which the bill treats the Corporation's waiver of exemption as ineffective. (The Secretary of the Treasury is to prescribe by regulations the manner in which such an arrangement for payment by an individual is to be made, and the Secretary of the Treasury and the Secretary of Health, Education and Welfare are to cooperate in assuring that each individual who is eligible to enter into such an arrangement will be notified and given an adequate opportunity to do so.)

The bill does not relieve the Corporation of any liability for the payment of taxes imposed by section 3111 of the Code with respect to any wages paid by it to any individual for any period.

Effective date

The provisions of the bill relating to wages paid to any employee after December 31, 1972, and prior to April 1, 1975, will not become effective unless, prior to the close of the one-year period beginning on the date of enactment, the Corporation furnishes to the Secretary of the Treasury evidence that it has refunded to such employee the full amount of taxes imposed by section 3101.

The provisions of the bill relating to wages paid to an individual as an employee of the Corporation after March 31, 1975, and prior to July 1, 1977, will not become effective unless, prior to the one-year period beginning on the date of enactment, the Corporation furnishes to the Secretary of the Treasury evidence that such individual was not an employee of the Corporation on June 30, 1978, and that no taxes under section 3101 of the Code were withheld from wages paid to such individual.

Revenue effect

The Service has assessed deficiencies totaling $182,914.96. This bill would reduce the deficiency assessment by $91,457.88, which is the sum of three components. First is the employee share of contributions under section 3101 betwen December 31, 1972 and April 1, 1975. Second, for individuals not employed by the taxpayer on June 30, 1978 the bill waives the employee share of contributions, between March 31, 1975 and July 1, 1977. Lastly, the bill waives interest and penalties with respect to contributions due for these periods for both employee and employer.

Departmental position

The Treasury Department does not oppose the bill but will recommend minor modifications.

3. S. 616—Senators Dole and Thurmond

Income, Gift, and Estate Tax Deduction for Contributions for the Construction or Maintenance of Buildings Housing Fraternal Organizations

Present law

Under present law, a deduction is allowed for Federal income tax purposes (with certain exceptions not relevant here) for contributions to certain specified types of organizations. In the case of contributions to a domestic fraternal society, order, or association, operating under the lodge system, a charitable income tax deduction is allowed only if the contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. In the case of the Federal estate and gift taxes, a transfer or gift to a fraternal society, order, or association operating under the lodge system is deductible only if (1) the transfer or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, (2) the fraternal society, order, or association would not be disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and (3) the fraternal society, order, or association does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

In addition, certain types of organizations are exempt from Federal income tax (other than unrelated business income tax). One of the types of organizations that is exempt from income tax are domestic fraternal societies, orders, or associations, operating under the lodge system if its net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and *fraternal* purposes and it does not provide for the payment of life, sick, accident, or other benefits (Code sec. 501(c)(10)). Thus, while the net earnings of an exempt fraternal society can be used for religious, charitable, scientific, literary, educational or fraternal purposes, a deduction is not allowable for a contribution to such a society if the contribution may be used for *fraternal* purposes. The Internal Revenue Service has ruled that contributions to an organization or fund for the purpose of acquiring, erecting, or maintaining a building to be used by a fraternal organization in carrying on its activities are not deductible even though some of its activities may be of a charitable nature. Rev. Rul. 56-329, 1956-2 C.B. 125.

Issue

The issue is whether a deduction should be allowed for Federal income, gift, and estate tax purposes for the contribution or gift to a domestic fraternal society, order, or association, operating under the

lodge system, for the construction or maintenance of a building which is principally used to house the organization.

Explanation of the bill

The bill would allow a deduction for Federal income, gift, and estate tax purposes for a contribution or gift to an organization described in section 501(c)(10) for the construction or maintenance of a building the principal purpose of which is to house the organization.

Effective date

The provisions of the bill would be effective for gifts or contributions made after the date of enactment.

Revenue effect

It is estimated that this bill will reduce budget receipts by $5 to $10 million annually.

Departmental position

The Treasury Department opposes the bill.

4. S. 687—Senators Chafee and Pell

Tax Treatment Under Rhode Island Indian Claims Settlement Act

Present law

In 1975, the Narragansett Indian Tribe brought suit against the State of Rhode Island and private landowners based on the Tribe's claims to certain land in Charlestown, Rhode Island. The Tribe argued that these lands had been alienated by it in 1880 in violation of the Trade and Intercourse Act of 1790. The Interior Department has held that the Tribe's claim is "credible." Prior to trial, the parties to the suit entered into a settlement agreement which required both State and Federal legislation for its implementation. Pursuant to the settlement, the Tribe's land claims have been extinguished. A public corporation (which is not a part of the State government) has been created under Rhode Island law with 5 directors to be appointed by the Tribe and 4 by State and local officials (the "Corporation"). The Corporation is to receive 1,060 acres of land now belonging to the State. Also pursuant to the settlement, a fund of $3.5 million has been established in the U.S. Treasury for the purpose of purchasing 900 acres of privately held land in Charlestown at fair market value from its owners. Options have already been secured on 550 acres of this land. The land, when acquired by the Secretary of the Interior with the proceeds of the fund, is to be conveyed to the Corporation.

All land owned by the Corporation is to be held in trust for the benefit of the Tribe. All of the land contributed by the State, and at least 75 percent of the land acquired from private owners, is to be permanently dedicated to conservation purposes. It is anticipated that the Tribe may use the remaining land in other ways which reflect its heritage, or to provide housing for poor or aged members of the Tribe.

The settlement agreement further provided "That the parties to the Lawsuits will support efforts to obtain deferral of both State and Federal income taxes resulting from the conveyance of privately held portions of the Settlement Lands."

The Federal Government's participation in the settlement is under the authority of the Rhode Island Indian Claims Settlement Act, passed in 1978. That law provided for the extinguishment of aboriginal Indian title, creation of the fund for the purchase of the privately held land, and transfer of that land to the corporation to be formed under the settlement agreement. It did not deal with any of the tax consequences of the settlement.[1]

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[1] As introduced, the bill (H.R. 12860, 95th Congress) contained tax provisions identical to the provisions of S. 687. It is understood that these tax provisions were eliminated from H.R. 12860 to expedite passage in the brief time which remained in the 95th Congress after consideration of the legislation in 1978.

While the Federal Government was not directly involved in drafting the settlement agreement itself, the Administration (through the White House, the Office of Management and Budget, and the Interior Department), the staffs of the House Interior and Insular Affairs Committee, the Senate Indian Affairs Committee, and the staffs of the Rhode Island Congressional delegation took part, along with the parties to the settlement agreement, in drafting the 1978 Settlement Act. Thus, these participants supported, with certain exceptions the entire agreement of the parties, including the tax provisions.

It is unclear whether, as the facts and circumstances develop, the Corporation could qualify for general exemption from Federal income tax (Code sec. 501). Also, the Corporation's receipt of land in settlement of the Tribe's damage claim might not be subject to income taxation.

Gain on the sale of property which is involuntarily converted (e.g., sold under threat or imminence of condemnation) may generally be deferred if the taxpayer, for the purpose of replacing the property, purchases property similar or related in service or use to the converted property, if the cost of the replacement property at least equals the amount realized in the conversion. (Code sec. 1033.) Generally, the replacement must occur within 2 years after the first year in which gain is realized. However, in the case of certain real property held for productive use in a trade or business or for investment, up to 3 years for replacement may be permitted.

Issues

The issues presented by the bill are:

(1) the extent to which the settlement land received by the Corporation should be exempt from tax;

(2) whether the private landowners who sell land pursuant to the settlement should be permitted to defer recognition of gain; and

(3) to what extent this bill should serve as precedent for the tax treatment of settlements of other similar suits brought by Indian tribes in other states.

Explanation of the bill

The bill generally would provide that the settlement land and any moneys received by the Corporation from the Treasury fund shall not be subject to any form of Federal, State, or local taxation. Thus, for example, the Corporation would not realize income on receipt of the land and the land would be exempt from local property taxes. (An exemption from local property taxes is also provided in the Rhode Island legislation creating the Corporation.) However, the general exemption rule would not apply to any income-producing activities occurring on the settlement lands, and nothing in the bill would prevent the imposition of payments in lieu of taxes on the Corporation for services provided in connection with the settlement lands. The bill would not affect the question of whether the Corporation generally qualifies for exemption from Federal income taxation.

The bill contains detailed rules as to the circumstances under which amounts received by the Corporation from the Treasury fund would be exempt from tax. However, under the mechanism actually adopted to implement the settlement, the Secretary of the Interior will use the fund to acquire land and will transfer the land to the Corporation, rather than transferring amounts from the fund to the Corporation to enable the Corporation to purchase the land directly. Accordingly, the Committee may wish to delete these provisions since they appear to be unnecessary.

The bill also would provide that, for Federal income tax purposes, any sale or disposition of private settlement lands pursuant to the terms and conditions of the settlement agreement is to be treated as an involuntary conversion. This would permit the sellers to defer gain on the sale to the extent allowed by section 1033.

Effective date

The provisions of the bill would be effective upon enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by a negligible amount annually for fiscal years 1980 through 1983.

Departmental position

The Treasury Department does not oppose the bill.

5. S. 736—Senator Dole

"Employment Tax Act of 1979"

Present law

a. Determination of status

Under present law, the classification of particular workers as employees or independent contractors for Federal income and employment tax purposes generally is determined under common law rules. Under the common law, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is to be accomplished," the relationship of employer and employee is deemed to exist.

In the late 1960's, the Internal Revenue Service increased enforcement of the employment tax laws. As a result, many controversies developed between the IRS and taxpayers concerning the proper classification of workers. These controversies affected a wide variety of workers, including insurance agents, direct sellers, pollsters, oil jobbers, and real estate agents. If the IRS prevailed in reclassifying a worker as an employee, the taxpayer became liable for employment taxes (withholding, social security, and unemployment) with respect to the reclassified workers. In many cases, these reclassifications involved a large number of workers and several tax years.

b. Employer—employee

(1) Social Security (FICA) taxes.—For calendar year 1979, employers and employees are required by the Federal Insurance Contributions Act (FICA) to pay social security (FICA) taxes of 6.13 percent each on the first $22,900 of the employee's wages, for a maximum of $1,403.77 each and a total of $2,807.54 per employee.

(2) Federal Unemployment Tax Act (FUTA) taxes.—The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages up to $6,000 per year paid to an employee. Generally, however, a maximum 2.7 percent credit is provided to employers who pay taxes under State unemployment compensation programs. The self-employed are not taxed by, nor included in, the Federal unemployment compensation program.

(3) Income tax withholding.—In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to individual employees must withhold for each pay period a portion of the wages to satisfy all, or part, of the employee's Federal income tax.

c. Self-employed individuals

Compensation paid to individuals who are self-employed is not subject to Federal income tax withholding. Rather, self-employed individuals must make quarterly payments of estimated tax directly to

the Treasury. For calendar year 1979, self-employed individuals with net self-employment earnings of $400 or more are required by the Self-Employment Contributions Act (SECA) to pay social security (SECA) tax of 8.10 percent on earnings up to $22,900, for a maximum SECA tax of $1,854.90.

d. Interim rule: Revenue Act of 1978

The Revenue Act of 1978 provided interim relief (until 1980) for certain taxpayers involved in controversies with the IRS concerning the proper classification of workers for employment tax purposes. In general, the Act terminated taxpayers' potential liabilities for Federal income tax withholding, social security and FUTA taxes in cases where taxpayers have a reasonable basis for treating workers other than as employees. In addition, the Act prohibited the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.

Issue

The issue is whether statutory standards should be adopted for use in the classification of some workers as independent contractors for employment tax purposes.

Explanation of the bill

The bill would create a statutory test for determining whether an individual would not be classified as an employee. To be an independent contractor under the bill, the following requirements would have to be met:

(1) the individual must control the aggregate number of hours actually worked and substantially all of the scheduling of the hours worked;

(2) the individual must not maintain a principal place of business, or, if he does so, his principal place of business must not be provided by the person for whom such service is performed, or, if it is so provided, the individual must pay such person rent for it. For purposes of this requirement, the individual would be deemed not to have a principal place of business if he does not perform substantially all the service at a single fixed location;

(3) the individual either must have a substantial investment in assets used in connection with the performance of the service, or must risk income fluctuations because his remuneration with respect to such service is directly related to sales or other output rather than to the number of hours actually worked;

(4) the individual must perform service pursuant to a written contract between the individual and the person for whom service is performed which was entered into before performance of the service, which provides that the individual will not be treated as an employee for purposes of employment taxes, and which provides the individual with written notice of his responsibility for payment of self-employment and income taxes; and

(5) the person for whom service is performed must file required information returns.

The bill would permit contracts entered into before January 1, 1981, to satisfy the written contract and notice of tax responsibilities require-

ment if the contract clearly indicates that the individual is not an employee and notice of tax responsibilities is provided to the individual by the payor before January 1, 1981.

The provisions of the bill would not apply to individuals who are designated in Code section 3121(d)(3) as employees (certain agent-drivers, commission-drivers, life insurance salesmen, home workers, and traveling or city salesmen).

Effective date

The provisions of the bill would apply to services performed after December 31, 1979.

Revenue effect

The revenue loss of this bill cannot be estimated because it generally affects individuals whose employment tax status under the present common law rules is the subject of dispute. Therefore, the effect of the bill on FICA, SECA, and FUTA tax liabilities and any effect of the bill's withholding changes on income tax collections are uncertain.

Departmental position

The Treasury Department opposes S. 736, because it would place an increasing number of workers outside of the existing system of withholding and thereby result in significant revenue losses due to the lower social security tax rate imposed upon independent contractors and the high rates of noncompliance in the payment of income and social security taxes that have been proven to exist among workers who are not subject to withholding. These revenue losses would be in addition to a revenue loss of at least $1 billion which the Treasury Department has estimated exists under present law from high noncompliance by independent contractors.

6. S. 945—Senators Mathias and Boren

Tax Treatment of Annuities Purchased for Employees of the Uniformed Services University of the Health Sciences

Present law

If an annuity is purchased for an employee by an exempt organization described in section 501(c)(3) of the Code or by a public school system, the employer's contributions for the annuity contract are, within certain limitations, excludable from the employee's gross income and not subject to tax until the employee receives payments under the annuity contract (sec. 403(b)). Subject also to limitations generally applicable to tax-qualified retirement plans, the amount excludable in any year cannot exceed 20 percent of the employee's current annual compensation times the number of years of service, less amounts contributed tax-free in prior years.

In P.L. 92-426, Congress authorized establishment (under the Department of Defense) of the Uniformed Services University of the Health Sciences in order to train medical students for the uniformed services. This legislation authorizes hiring civilian faculty and staff members at salary schedules and with retirement benefits similar to those given to the faculty and staff of medical schools in the Washington, D.C. area. On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for the faculty, similar to annuities available at certain medical schools in the Washington area and throughout the United States. However, because the University is a Federal instrumentality and is not an exempt organization described in section 501(c)(3), the annuities do not qualify under present law for tax deferral pursuant to section 403(b).

Issue

The issue is whether annuities purchased for the civilian faculty and staff of the Uniformed Services University of the Health Sciences should qualify for income tax deferral in the same manner as annuities purchased for employees of exempt organizations described in section 501(c)(3) or of public school systems.

Explanation of the bill

The bill would treat otherwise qualified annuities purchased for the civilian staff and faculty of the Uniformed Services University of the Health Sciences in the same manner for income tax purposes (sec. 403(b)) as employee annuities purchased by section 501(c)(3) organizations or by public school systems. Any qualified annuity purchased by the University would be subject to the same limitations as other annuities described in section 403(b).

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Effective date

This bill would apply to annuities purchased for service performed after December 31, 1977, in taxable years ending after that date.

Revenue effect

The bill would decrease budget receipts by less than $1 million per year.

Departmental position

The Treasury Department does not oppose the bill.

Prior Congressional action

In the 95th Congress, an identical bill (H.R. 12606) passed the House, but was not acted upon by the Senate Finance Committee or considered by the Senate.

7 S. 1514—Senators Byrd (Va.) and Warner

Tax Treatment of Interest Paid on Certain Government Obligations Issued for Facilities That Convert Solid Waste Into Energy

Present law

Under present law (Code sec. 103), interest on State and local government bonds generally is exempt from Federal income taxation. However, with certain exceptions, interest on industrial development bonds [1] is not exempt from Federal income taxation.

One of the exceptions permits tax-exempt industrial development bonds for solid waste disposal facilities (Code sec. 103(b)(4)(E)). While not defined by the Code, the regulations define solid waste disposal facilities as any property or portion thereof used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. In addition, the fact that a facility which otherwise qualifies as a solid waste disposal facility operates at a profit will not, of itself, disqualify the facility as an exempt facility. A facility which otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than a solid waste disposal merely because material or heat which has utility or value is recovered or results from the disposal process. Where materials or heat are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are in fact sold or used, but does not include further processing which converts the materials or heat into other products. For example, solid waste disposal facilities includes the cost of facilities used to burn the solid waste and to convert the resulting heat into steam in a marketable form. However, the cost of transportation pipes or electrical generation equipment [2] used to convert the steam into electricity would not qualify.

In addition, the Internal Revenue Service takes the position that tax-exempt industrial development bonds cannot be used to finance facilities that are used by the United States or its agencies. Tax exemption is denied because the bonds would, in substance, be backed by the Federal Government and, thus, the bonds would be both tax-exempt and Federally insured.

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[1] Under Code section 103(b), a State or local government obligation is an industrial development bond if all or a major portion of the proceeds are to be used directly or indirectly in a trade or business of a person (other than a government unit or a tax-exempt organization) and payment of the principal or interest on the obligation is secured by an interest in, or derived from the payment with respect to, property used in a trade or business.

[2] Under present law, tax-exempt industrial development bonds can be used to finance electrical generation equipment where the facilities are used in the local furnishing of electric energy or gas. (Code sec. 103(b)(4)(E)). Local furnishing of electric energy is defined generally to mean furnishing solely within two contigous counties or a city and a contiguous county.

Issues

The issues are:

(1) Whether tax-exempt industrial development bonds should be used to finance electrical generation equipment (or other energy-producing equipment which functions after the energy or materials derived from solid waste disposal process has been put into its first marketable form) operated by a government which is located on the same site as, or adjacent to, the solid waste disposal facilities where the fuel used to power the electrical generation equipment is solid waste.

(2) Whether tax-exempt industrial development bonds for solid waste disposal facilities should be permitted where the user of the facilities is the United States Government or its agencies.

Explanation of the bill

The bill would make basically two amendments to the provisions of the Code permitting tax-exempt industrial development bonds for solid waste facilities. First, the bill defines the term "solid waste disposal facilities" to include any facility which has the function of recovering material from solid waste and any facility, operated by or on behalf of the governmental unit, which has the function of producing gas, heat, or energy, directly or indirectly, from the solid waste disposal process and which is located at the same place as, or adjacent to, a solid waste disposal facility.

Second, the bill provides that industrial development bonds used to finance solid waste disposal facilities may be tax-exempt where the facility or any materials, gas, heat or energy that is recovered or results from the disposal process is to be used by, or for the benefit of, an agency or instrumentality of the United States Government or where the payment of the principal or interest on the bonds is to be derived, in whole or in part, from payments made by an agency or instrumentality of the United States Government.

Effective date

The provision of the bill would apply to obligations issued after June 30, 1979.

Revenue effect

It is estimated that this bill will reduce budget receipts by $3 million in fiscal year 1980, $14 million in 1981, $39 million in 1982, $81 million in 1983, and $125 million in fiscal year 1984.

Departmental position

The Treasury Department opposes the bill.

Senator BYRD. The hearings will begin with testimony of Mr. Donald C. Lubick, Assistant Secretary for Tax Policy, the Department of the Treasury.

I understand that, in addition to the testimony, the representative of the Department of Treasury will be available throughout the hearing to answer further questions which may emerge during the testimony of other witnesses.

Mr. Lubick, you are most welcome, and you may proceed with your observations.

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. LUBICK. Thank you, Mr. Chairman.

If you please, I would like to submit the written statement for the record.

Senator BYRD. Yes. It will be published in full.

Mr. LUBICK. I would like to talk primarily about the problem of independent contractors, Mr. Chairman, and a brief word at the end about fringe benefits, and then we would be pleased to answer questions on any of the bills before you.

Senator BYRD. If you would delay a moment, that is, S. 736?

Mr. LUBICK. Right, and the fringe benefit bill is 224, if I am not mistaken.

Senator BYRD. 224, yes.

Which one do you want to discuss first?

Mr. LUBICK. S. 736, independent contractors.

We are dealing here, Mr. Chairman, with an area where we have had a great deal of difficulty in classifying workers as employees or independent businessmen. The workers involved are in a broad spectrum of areas of employment; persons performing the same tasks may be variously classified in those industries as independent contractors, or employees.

We have cases that involve entertainers, salesmen, construction workers, fishermen. The consequences of classification are significant.

First of all, if a worker is classified as an employee he is subject to wage withholding at graduated rates on the payments that he receives as compensation.

Second, the taxation of his wages for social security purposes is different. If he is an employee, the payor of the compensation pays 6.13 percent of the wage base. There is withheld from his wages a comparable 6.13 percent, making an aggregate payment to the social security trust fund of 12.26 percent.

On the other hand, if he is an independent contractor, nothing is withheld by the payor. Nothing is paid by the payor. He files a return of self-employment tax and pays 8.1 percent. So there is a different burden.

Thus, there is an incentive in dollar terms to avoid employee status. There is the savings to the employer of the payroll tax cost or an avoidance to the worker of the necessity of withholding.

Senator BYRD. When you say "payroll tax cost" you are speaking primarily, I assume, of social security?

Mr. LUBICK. That is correct.

Senator BYRD. By the same token, they do not participate in the benefits of social security, do they?

Mr. LUBICK. No, they get the same benefits, Mr. Chairman, based upon their taxable compensation. The benefits are identical but the contribution, the premium, is substantially higher going into the trust fund if the worker is classified as an employee, because there is 6.13 percent paid by the employee and 6.13 percent by the employer, a total of 12.26.

The 8.1 percent self-employment tax was arrived at originally as a way to more or less equate the fact that the employer who pays his 6.13 percent gets an income tax deduction for it, whereas none of the self-employment tax is deductible.

So originally, you had the self-employment tax running at a rate of 1.5 times taking into account a 50-percent deduction of the employer portion. It has gotten out of line, although there is a schedule to bring it back towards that ratio again in future years.

Senator PACKWOOD. May I ask a question, Mr. Chairman?

Senator BYRD. Senator Packwood.

Senator PACKWOOD. I started to read your statement, Mr. Secretary. Two things.

I am looking at page 2 of your statement. You presume that all the social security tax paid by the employer, in essence, is really paid by the employee on the theory that there are that many wages that that employee gets?

Mr. LUBICK. Basically, that is the economic analysis that we believe is accurate.

Senator PACKWOOD. Do you take the same philosphy against any fringe benefit that the employer trades off against the wage increase?

Mr. LUBICK. I hesitate to say "any." That is a correct analysis, because these are costs that the employer takes as a part of his compensation base. In the long run, they reflect themselves in lower cash wages.

Senator PACKWOOD. Second, I see this statistic. I want to make sure I understand it. Forty-seven percent of the workers who are independent contractors report none of their compensation for income tax purposes.

Mr. LUBICK. Basically, Senator Packwood, we are dealing with a study of a selected group of independent contractors, where we have a gray area as to their classification as employees, or independent contractors.

The survey did not purport to deal with a plumber who runs around all day doing various jobs, because nobody has ever seriously considered him to be an employee, but in the type of worker we are talking about, in the gray area of employee-independent contractor, the study that we undertook this year demonstrated that 47 percent of the workers in this area reported none of their compensation for income tax purposes. They may have had other income that was reported, but we are dealing only with the compensation paid to them as workers with respect to where a doubt arises whether they are an employee or independent contractor.

Senator PACKWOOD. They reported none of it as income?

Mr. LUBICK. That is correct.

Senator PACKWOOD. You are not talking about the problem of social security taxes, but the whole tax structure?

Mr. LUBICK. With respect to social security, the zero noncompliance rate was 62 percent. I have some charts that I will ask Mr. Lerman to unveil here that show the results of this survey.

Do you want to show chart 1 first?

Chart 1 shows the percentage of workers with zero compliance by the size of their compensation. You will notice that there is a tendency, as the amounts of compensation get larger, to have a better, although still not a good rate, of compliance.

You will notice that in the very smallest ranges we have noncompliance rates that run over 75 percent.

Senator BYRD. But practically no money is involved.

Mr. LUBICK. There is a lot of money involved, as far as the overall revenue is concerned. For any one individual, the amount is not much, but even when you get into amounts—take, for example, the $2,000 to $5,000 compensation, you will have close to 40 percent noncompliance of persons that are receiving payments that aggregate between $2,000 and $5,000.

Senator BYRD. Is it not correct that if you eliminate those very small amounts where you get to $1,000, then the noncompliance rate would not average any such figure as 47 percent?

Mr. LUBICK. Mr. Chairman, I want you to understand that these are not figures that refer to the incomes of those individuals. It is not adjusted gross income. They may have other income that puts them into significant tax brackets, but the noncompliance problem, even at $1,000 in that category, $1,000 to $2,000, more than half of this income—51.5 percent—more than half of this income is not being reported at all. And when you look at the social security aspects of it—I do not have that broken down into these categories—the overall noncompliance, the overall zero compliance rate with respect to amounts going into the social security trust fund was 62 percent.

That, of course, is very serious with respect to, in some cases, the entitlement of low-paid workers to beneifts; they may not get benefits. In any event, it certainly affects the integrity of the fund.

Senator BYRD. If they do not pay into the social security fund, they do not get the benefits, do they?

Mr. LUBICK. That is true if a worker is classified as self-employed. It is not true if he can establish that he should have been classified as an employee.

There is some doubt on that score, but that is true. Generally speaking, if a person is really an independent contractor he may be cutting off his own nose to spite his face and may end up a welfare burden, as far as we are concerned, because he does not have social security.

Senator BYRD. Mr. Secretary, I do not want to indicate, in any way, that I feel individuals who owe a tax ought not to pay the tax. I think by all means they should.

My only quarrel with your chart is that you get that overall figure of 47 percent, which you have been quoting, is achieved by using de-minimis figures. You are talking about less than $100—I do not see that that is a matter of grave concern.

Technically, it should be reported, and I should like to see it reported; but to talk about changing this whole system just because of somebody who got less than $100 and did not report it as an independent contractor, that does not seem to me to be very logical. When you get into these higher figures, I think you raise some good points.

Mr. LUBICK. Mr. Chairman, I think if you cross out those first two lines you have a totally unacceptable noncompliance ratio. If you are talking about payments of $200 to $500, you have a noncompliance rate of 66.6 percent. This is zero noncompliance. I am not talking about total noncompliance, which is even greater.

If you had a worker who reported half of his income, there is still some noncompliance. We have not even taken that into account on this chart.

I might also add, Mr. Chairman, in the survey, there were a number of workers who went into the original sample that we were not able to find. We did not count them, either.

The odds are if a worker disappears, a no-show and you cannot find him, he is not going to have a better record of compliance than those people whom you are able to place and put your hands on.

What we are trying to show is that these figures indicate a shockingly high rate of noncompliance that permeates all income brackets. If you look at persons receiving payments between $20,000 and $50,000 and you have a noncompliance rate of 11 percent, that is extremely high, and unjustifiable.

If you would look at compliance ratios where we have wage withholding by employees, you are dealing in the 98-percent compliance bracket.

To have figures where you have payments received between $1,000 and $2,000 and have more than half of it not reported I think is a shocking example of noncompliance.

If we move to chart 2 which is a variation of the same theme—and I would also like to show chart 3—Chart 2 shows that noncompliance by adjusted gross income and again shows these high noncompliance rates up the income scale and chart 3—these charts, incidentally, Senator Chafee, are attached as exhibits to the statement if you want to refer to any of them which are not on display.

If you look, industry by industry, the only industry that comes in anywhere near a respectable showing is the insurance industry, but by and large, we can see that this problem is pervasive all through industries.

Now, the basic test that has been in effect has been the common law test involving some 20 factors, designed to determine whether a worker is an employee or an independent contractor, tests that were derived from the English common law of master and servant. We have had great pressure during past years for the Service to classify workers as employees and for employers to resist that categorization for the reasons that I explained.

Last year, the committee and the Congress placed a moratorium and washed out liability with respect to the back years in order to deal with this problem. The question was raised last year, was there really a noncompliance problem? Is there a serious problem that deserves attention? And in response to that, we did this sur-

vey. We believe that it has been demonstrated conclusively that there is a problem, and it is not only we who believe this.

Our materials were reviewed by the GAO to give an independent appraisal of the situation and the GAO has recently concluded its review of our technique and our survey and has concluded that our results are an accurate reflection of a very serious noncompliance problem in this area.

Last year, the industries that were involved suggested that attempts by us to reclassify workers as employees have very serious consequences aside from the tax law. It could affect their labor relations if we called them employees for tax purposes. It might affect how they were treated for labor law purposes. It might affect workman's compensation liabilities. It might affect minimum wage problems.

We have no desire to intervene one way or the other to try to influence the outcome in areas other than the collection of the revenue and the security of the social security fund.

Senator PACKWOOD. If I may ask a question there so I can understand, on chart 3, the percentage of workers with zero compliance by industry is 69.5 percent in logging and timber, which is an industry, I know.

That figure does not mean that 69.5 percent of the people who work in the logging and timber industry. What does the figure mean?

Mr. LUBICK. We are dealing only with those groups of employees who are in the gray area as to whether they are employees or independent contractors. For those timber operations where you have further classification of the workers as employees, I assume the rate of compliance has probably got to be exactly the same as it is across the country, roughly 98 to 99 percent.

We are only dealing with those areas where some timber operators may try to classify their workers as independent contractors, so that they are not under the law subject to wage withholding.

In the area of that segment of workers, you have a degree of noncompliance. This is not a figure of noncompliance of all the workers in the logging industry or any other industry.

Senator PACKWOOD. It would not include, for example, most of the people involved in independent contracting, reforestation, where they bid for the Forest Service or bid on the warehouse or bid on reforestation and then they go out and plant. They would be independent contractors?

Mr. LUBICK. I am not clear. Are they completely independent contractors? There has been no question about their classification? I am not sure.

Senator PACKWOOD. I do not think there would be any question, or for those who cut timber in a certain area for somebody.

Mr. LUBICK. Our survey primarily, as I understand it, deals with timber cutters where you have a company that says we are going to have 100 people and we will pay you so much a tree, or whatever it is, to cut down. You are in an area where they tell them where to cut and when to show up and they claim you are independent contractors.

As I understand it, there are variations as to how the employers treat these workers. Some workers, doing the same thing, paid the same wage, will be classified as employees; others will not.

Senator PACKWOOD. What I want to know is this. I know the kind you mean. A major company will contract with X Logging Company to cut timber for them. You can have a serious argument as to whether they are independent contractors or not, but presuming, as far as the employee contract, or company, is concerned, if they call them independents and do not withhold anything, you are telling me that roughly 70 percent of those people who receive payments from the timber company have not paid any tax on it?

Mr. LUBICK. They are not reporting any of this. They are not paying any tax on this compensation. That is correct.

Senator CHAFEE. Mr. Lubick, one problem, it seems to me, is that, despite what you say on page 2 of your testimony that the independent contractor's social security contribution is lower than the tax for an employee of a corporation, it does not seem that way to the independent contractor. If he is working for an employer, he is paying only 6.13 percent.

Mr. LUBICK. The direct withholding is less, except that the direct withholding of 6.13 is based on his direct compensation. The 8.1 is based on net. He can deduct his expenses. There is some narrowing of the gap there.

Senator CHAFEE. If he is an employee, presumably he does not have expenses, or at least they are minimal compared to those of an independent contractor.

The point that I am making, is that an independent contractor might feel he ought not to pay this tax because he is really being discriminated against in that he ends up paying a higher tax than if he was on a warehouse payroll.

Mr. LUBICK. The economics, as I indicated earlier to Senator Packwood, are that ultimately this is reflected in the amount of the compensation package to him. The economists have demonstrated pretty well that the payroll tax that the employer pays, the 6.13 percent, the employer has to take into account as a part of his wage burden. It may be that somewhere, the difference between the 8.1 and the 12.26 is split between the employer and the employee, but certainly the employer, in setting his total compensation package has to take into account the fact that he makes a payroll tax contribution to the social security trust fund of 6.13 percent that is excluded in the income of the employee.

The result, in any event, Senator Chafee, is that premiums being paid to own social insurance are going in—to the extent that there is an actuarial tie—are going in at a lower rate.

As I indicated, our first test was to demonstrate that there is a serious noncompliance problem. It has been reviewed by our special study, by our general study of the underground economy, by a GAO study, and the GAO review of our study. The GAO has concluded that the most serious area of noncompliance is, indeed, in the area of self-employed persons, of whom the independent contractors who are involved in this particular study are a very significant segment.

At the same time, as I indicated, we do not want to interfere with business practices and we recognized that the industries in-

volved wanted to maintain the integrity, or the independence, of their workers as independent businessmen, and therefore, rather than pursuing the approach that was being explored last year by the Internal Revenue Service on audit, of trying to reclassify workers as employees and to get graduated rate withholding, we thought we would try a different approach that would accommodate their needs and, at the same time, help deal with this problem of massive noncompliance.

So we suggested that the centerpiece of a program to deal with this problem ought to be, instead of graduated withholding, instead of reclassifying these persons as employees, that we would recognize their independent status, but apply a flat rate, 10 percent withholding. Certainly 10 percent is about as easy a number to work with in determining the withholding on the wage base as one could arrive at. It is certainly much simpler than graduated withholding that goes up the scale on rates.

Furthermore, in the case of those workers who file with the payor a certificate stating that they will be overwithheld with respect to their obligations to pay the 8.1 percent and income tax, they would be exempted from withholding, so we would not have overwithholding on those workers.

Furthermore, in the case of those persons who may or may not present a noncompliance problem but who work, or perform the same line of services for five or more different payors, we would exempt them from the system. Essentially we are trying to get the very serious problem area without achieving Valhalla and trying to deal with all of the problems.

We are dealing with those cases where a worker is performing services for four or less payors, so essentially, he looks a lot more like his brother employee.

At the same time we would strengthen the information reporting, and it is my understanding that the industries involved have not objected to information reporting. Information reporting requires the payor to get the name, the social security number and the address of the worker, and therefore he has got all of the information to furnish him with a withholding certificate and an information withholding certificate. All he has to do is withhold the 10 percent of the wage base.

So it appears to us that this involves no additional work of any consequence whatsoever. As a matter of fact, any cost would be more than compensated by the fact that the payor would have the use of the withheld funds for whatever period is required until they have to be paid over to the depositor. And, therefore, we believe we have come up with a system that the American Institute of Certified Public Accountants has already said is workable, it is feasible, it will deal with this noncompliance area. It recognizes the concerns of the industry to maintain the independence and the system under which they have been operating with respect to their workers. There really seems to be no reason why we should not take this step to demonstrate to the American people—to those people who are fully paying their tax liability because they are withheld—that we are not going to condone a large segment of our economy not paying taxes on their compensation and we are going

to do it in such a way as not to impose burdens on the industries involved, so as not to affect longstanding relationships.

We believe that this approach will move in that direction and will be a significant step that this committee can take to show that all Americans have to bear their share of the burden that we will not tolerate simple tax evasion or noncompliance, whether it be deliberate or inadvertent through misunderstanding.

Senator BYRD. Mr. Secretary, under your proposals, as I understand it, the status of the independent contractor would not be changed?

Mr. LUBICK. That is correct.

We have tried not to disturb that relationship at all. The independent contractor would still be different from the employee. The independent contractor would not be subject to graduated withholding. He would be subject, instead, to the 10-percent rate.

And, in the event that we had a situation where the worker was reclassified as an employee, we have proposed reducing the penalty. Formerly that was a pretty horrendous step for the employer, because he became liable for 100 percent of the payroll taxes, the employee's share and the employer's share.

We suggest that if he withholds the 10 percent and it turns out that he was erroneous, that this fellow should have been an employee and he should have withheld at a graduated rate, we will not collect anything more than the employer's share of the social security tax that he would have been liable for anyway.

We, in effect, by putting this 10 percent withholding on independent contractors believe that we have eliminated the incentive to misclassify.

First of all, the Service is not going to go out and try to press for the very doubtful cases because it will not stand to pick up anything significant. The employer is not going to have the incentive to misclassify because his workers have been subject to withholding, and perhaps and probably they may owe a difference over and above the withholding, but that is very different than coming up with the entire amount.

In that case, we believe that both the industries involved and the workers will not have the incentive to misclassify. We believe we will have taken all of the tension out of this problem that allows the industries to operate without significant cost to them, that allows us to protect the revenue, and it gives the worker the information reports that they need to prepare their tax returns.

Really, Mr. Chairman, it looks like a perfect solution, one that hurts no one and yet establishes the principle of compliance.

Senator BYRD. Mr. Secretary, I think it is very important that independent contractors pay their just share of the tax burden. I think that is very important. I think they are obligated to do so, and they should do so. But now you have stepped up your audits of independent contractors. Do you find that has made a difference, or not?

Mr. LUBICK. The step-up in audit, of course, Mr. Chairman, led to the terrible difficulties that we had over the past few years and led the Congress to put the freeze on that is in effect at this time.

Certainly it makes a difference.

Senator BYRD. If an independent contractor evades taxes that he is obligated to pay, he is subject to penalty just as much as anybody else is.

Mr. LUBICK. That is true, Mr. Chairman. Unfortunately, the resources of the Service for audit are limited. It is well-known that the audit coverage of the Service is roughly 2 percent of the returns.

In allocating its resources the Service will tend—although not entirely—to deal with those areas where the dollar amounts are the largest. So you will find that the ability of the Service to allocate resources on audit to solve these problems is just not there. I do not think you would want the Service to be going around and chasing hundreds and hundreds of people with respect to $100 and $200 payments to collect 10 percent of that amount.

It would not be economic. It would be regarded as harrassment by the Internal Revenue Service. It is a system that we have not been willing to impose with respect to employees.

Indeed, the withholding system is essential to the self-assessment system, which is the cornerstone of our tax collections and there is no reason why the simple flat rate withholding should not produce the same salutory results in the independent contractor area. It is really the only way that is practical to deal with this noncompliance problem.

Senator BYRD. Let me ask you one final question. Is it the Treasury's ultimate, long-range goal to make all workers employees?

Mr. LUBICK. No, sir, and we have deliberately avoided that approach. That is exactly the direction in which we do not want to go and we think the proposal that we have made avoids that trap and avoids that approach.

It seems to us, Mr. Chairman, whether a person is an employee or an independent contractor, whether the law as developed in ancient England in the 15th century whether the person is liable for the torts of another has no relevance to an obligation to pay taxes. That obligation exists, regardless of how a person is classified.

Therefore, we do not want to interfere with these doctrines of classification of employee-independent contractor which may have meaning in a number of areas, but not in the area of taxation.

Therefore, we have suggested an approach that avoids going down that road of classifying more people as employees. Let them be called independent contractors. Let them continue to have that independence. For all purposes, they will be recognized as such, by having a separate, flat, 10-percent rate of withholding, easy to calculate.

Information returns will be given. The whole existing system of employment will continue in exactly the same way, but yet we would have solved our revenue problem which has no relevance to that of the classification problem. We would have eliminated a red herring from this whole area.

Senator BYRD. What would be the revenue gain?

Mr. LUBICK. We have conservatively estimated that we should pick up at least $600 million from the institution of this withholding system. We have conservatively estimated that we are losing over $1 billion in revenue at this time and I want to stress that we

have tried to be as conservative as possible. It is very likely that the noncompliance and the loss is much higher than that, but we have been making this proposal to you to be on the conservative side. We would be glad to go over that with you.

We have tried to make every assumption on a conservative basis so as not to overstate the magnitude of the problem.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. No questions.

Senator BYRD. Senator Chafee?

Senator CHAFEE. A couple of quick questions, Mr. Lubick.

Are you trying to collect social security taxes, or are you trying to collect income taxes. You are trying to do both?

Mr. LUBICK. The latter, both. The 10 percent would be applied first to the social security obiligations and the balance to the income tax obligations.

Senator CHAFEE. This $600 million figure, that is the total?

Mr. LUBICK. That is the total.

Senator CHAFEE. All of it would not go to the social security fund?

Mr. LUBICK. No; It is about two-thirds income tax and one-third social security.

Senator CHAFEE. It seems to me if you are trying to do both, a 10-percent figure is probably lower, is it not, except it is on gross?

Mr. LUBICK. That is correct, Senator Chafee. It is low. We wanted to avoid a significant amount of overwithholding. We also believe that if we get the 10 percent that the worker will have relatively little difference to put himself—when you take into account his exemptions and deductions and so on—to put himself to full compliance. And where he has to go from 10 percent to a few more dollars to be in compliance, the desire to be a law-abiding, compliant citizen will get him that distance. Whereas if you have no withholding whatsoever and no paper in his hand as to what his obligations are, even without any regard to evading, it is much more difficult for a worker to report fairly.

He does not even have—if he is not a recordkeeper—the information to report on his return that you have when you go about to make out your tax return.

Senator CHAFEE. It is important to remember we are not just talking about the sturdy, independent woodcutter somewhere. We are talking about some very high-priced independent contractors here. Of course, all lawyers in a partnership that is not incorporated, a group that has not chosen to incorporate.

Mr. LUBICK. Most of the lawyers, Senator Chafee, would probably perform work for at least five clients and then we would take them out of the system.

Senator CHAFEE. I see. I was not seeking to defend them. I was trying to catch them.

Now, I suppose there are some counterarguments. I suppose those will come from the gentlemen with you at your panel?

Mr. LUBICK. The gentlemen with me, I think, have worked hard. I have put them to work for weeks to think of counterarguments and they have failed. They have not come up with anything.

Senator CHAFEE. So we can just assume by their silence today that they are in accordance with your views.

Mr. LUBICK. Their silence indicates acquiescence.

Senator CHAFEE. I have no further questions. Thank you, Mr. Chairman.

Mr. LUBICK. Mr. Chairman, may I spend about 1 or 2 minutes on S. 224, which would permanently extend the prohibition on the issuance of fringe benefit regulations which is scheduled to expire this year on December 31, 1979, and which the Ways and Means Committee has recently proposed to extend to June 1, 1981. This is a bill which would prohibit the issuance of regulations—it does not change the statutory rule as to what is included in income and what is not. The rule still is that compensation paid in kind unless explicitly exempted, as a number of provisions do, is still taxable. Senator Packwood knows the list. As a matter of fact, he has a long list of additional ones that he would like to enact into the substantive law. If one wishes to arrive at that result, I think enactment of substantive changes in the law is the way to do it, not riders on appropriations bills or prohibitions on regulations, but basically the payment of compensation in kind is still taxable.

There is still a recognition that, generally speaking, it is equitable that one pay tax on his compensation received in kind. Indeed, Senator Packwood's bill stresses exceptions only where there are broad, nondiscriminatory plans which I think is a different situation.

There is also a question of the revenue. If all manner of fringe benefits are allowed to go untaxed, then we move toward a barter system. As a matter of fact, on one occasion recently I jokingly proposed that the way things were moving these days, we ought to provide an exemption for wages paid in cash as an incentive to get employers back to that mode of compensation.

But we have pledged ourselves not to make significant changes in the IRS administrative practice with respect to fringe benefits and we believe one ought to recognize there are a number of noncompensatory, business-related types of benefits that ought not to be taxed.

We do not want to be a nuisance and go after small, de minimis items that do not cause problems.

Senator BYRD. Now, what do you want to tax. Let's have a list of what you want to tax.

Mr. LUBICK. What I would like to do, Senator Byrd, is to be free to undertake a project and to lay it all out in a notice of proposed rulemaking so everybody can see exactly what we think the rules ought to be.

Senator BYRD. Why do you not present it to this committee, and we could consider it right now?

Mr. LUBICK. I am not prepared to do that right now, because it is a very difficult question, but I would suggest that this piece of legislation would prevent us from doing it because it puts a freeze on us even coming up with proposed regulations.

What I would like to do is come up with the proposed regulations sometime next year, put them out so that——

Senator BYRD. Give it to this committee. Why not make the proposal to this committee? This is nothing new. Why do you not have something to present to us now?

Mr. LUBICK. We have been operating under the freeze and as we started to work on the problem, a few other pressing matters came along. Since we were under a freeze, there was not any particular rush to do it, to get it out.

We would like to be able to come out with a proposal, let the committee look at it, make what changes in the law you think are appropriate, but we think to have a complete freeze permanently on our even working on the problem or coming out with any rules is just going to lead to chaos in administration.

Senator BYRD. What would you think about changing the proposed legislation, that the freeze would continue until such time you submit your proposal and your proposal is approved by the Congress?

Mr. LUBICK. I think that Congress has the right to change the law any time it wants. I do not think—we are obligated to enforce the law as it exists. Whether we have a regulation or not, the Internal Revenue Service is still obligated to enforce the law. That means they may be enforcing the law differently in Norfolk, Va., from Portland, Oreg., or Peoria, Ill., or Topeka, Kans.

You are going to have different results in the situation we have now; the purpose of a regulation is to let the public know and to set forth some standards as to what the rules ought to be. It would go out in proposed form.

Senator BYRD. I am trying to be helpful to you. I think we are entitled to know—the Congress is entitled to know—what you have in mind.

Mr. LUBICK. You are absolutely right. This bill would prevent us from telling you.

Senator BYRD. I do not think the bill prevents you from telling us. If it does, I will introduce an amendment to permit you to tell us what is going on.

Mr. LUBICK. In other words, you would permit us to put out the proposed regulations?

Senator BYRD. I would permit you to submit the information to the Congress.

Mr. LUBICK. We do that. We traditionally interpret the statute by putting out the proposed regulations and that has rarely escaped the attention of the Congress, and that is really the orderly way to interpret the statute, which imposes an obligation on us to enforce it.

We think that is the appropriate way. We are not going to put anything into effect, either retroactively or without the Congress having a full chance to pass on it.

Senator BYRD. I do not see why you are opposed to what I have suggested, if that is the case.

Mr. LUBICK. I am not sure I am opposing what you are suggesting. I am suggesting that I think we are probably in accord. We would come out with a notice of proposed rulemaking. The world would see it. The public would see it. The Congress would see it.

We would not make it effective until a substantial period after it has been put out, certainly not during 1980.

Senator BYRD. Could you give us some examples of what you have in mind in the way of taxing fringe benefits.

Mr. LUBICK. Basically, there are two areas that are the problem areas, Mr. Chairman. They involve payments by employers in kind of the product of the employer. It might be that General Motors would decide to compensate its employees by passing out to them Chevrolets and if that is intended to be compensation, they perhaps may be taxable on the fair market value.

Senator BYRD. Is that being done now.

Mr. LUBICK. It is being done, to an extent.

Senator BYRD. Passing out Chevrolets?

Mr. LUBICK. Not totally. Chevrolets, Cadillacs, Buicks, Oldsmobiles, at cost. I think that that is one area that is a serious problem.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. Mr. Secretary, you and I have discussed this philosophy for years and I notice that there is one statement in here that the IRS is not going to try to collect taxes on inconsequential employee benefits. Although this subject, as far as I am concerned, started 4 years ago when IRS attempted to collect taxes on the value of the premiums paid on prepaid legal insurance from members of the Laborers Union and the value of those premiums were $60 a year and the laborers are not among the higher paid of the building trades.

I thought that was about as de minimis as you could get, yet that is where the problem started. In your mind, if you are going to go that low, as $60 a year, then I can think of very few fringe benefits that fall under that figure.

Mr. LUBICK. I do not know that I want to commit myself at this time to any appropriate number. That is certainly one of the areas that is important to study.

I think that we have to know what is an appropriate number and if, indeed, there is a uniform number, depending on the type of benefit. The situation that you were dealing with, Senator Packwood, whether I agree basically with the legislation or not, certainly on the merit of requiring a nondiscriminatory plan it followed in the pattern, the longstanding pattern, of statutory exemption for health plans; I guess it went even further, because it had nondiscrimination.

Last year, it went even further because it had nondiscrimination. Last year, you had a similar proposal with respect to education plans. Those situations, I can assure you, particularly in the way in which you packaged those proposals with the conditions and restrictions, do not present the same problems of equity or danger to the revenue that involve a lot of the problems that we are dealing with in this area, and I believe from some of the remarks that you have made that when one is dealing with discriminatory devices to restate compensation to minimize tax in the form of compensation in kind, on a barter system, that is not in accordance with the objective that you want to achieve in this area.

Senator PACKWOOD. You and I are as one at that point. I have no desire to support a fringe benefit system that says those who make $25,000 and up will be entitled to certain benefits; those below, will not. On that I agree with you.

If that was the only point of difference, I could give you a whole list of benefits that I would like to exempt and put nondiscrimina-

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tion clauses on all of them. I would start with airline travel, day care and meals and transportation provided by employers other than vanpooling, Metro tickets to encourage people to get out of their cars; if the administration wants to go down that line with me on a whole series of these, I will be happy to agree on the nondiscrimination.

Mr. LUBICK. I am not going to accept your invitation at this time, but in connection with our studies in this area, on many of the de minimis fringe benefits, one of the lines that we have talked about includes just that line that you have suggested. If you are talking about de minimis benefits on a nondiscriminatory basis, our attitude would be very, very different and would be much closer to yours. I think what we want is the elbowroom to work through this whole problem and come up with a proposal that will give you ample opportunity to respond and to achieve the result which the Congress believes is equitable and administerable and upholds the integrity of the tax system.

But if we follow S. 224, we do not even have the opportunity to do that, and we will have our agents going all over the place in all different directions. There will be no uniformity. Nobody will know what the rules are. We will not be able to tell anybody.

Gradually, over 10 or 15 years, it will work its way up through the courts and you will have a body of decisions, but it is not a very orderly way to proceed.

Senator PACKWOOD. I have no further questions, Mr. Chairman.

Senator BYRD. Senator Dole?

Incidentally, Treasury testimony on independent contractors was considered just a few moments ago.

Senator DOLE. I have arrived a little late, but I assume Mr. Lubick favored my legislation.

Senator BYRD. His enthusiasm was restrained.

Mr. LUBICK. I think, Senator Dole, if you had heard what I had to say, you will see that what we are proposing is certainly compatible with your objective. I am looking forward to the opportunity to talk with you about some of these problems. I think we have found a way to keep all the affected industries from having any undue burdens and to secure compliance with the tax laws and to promote all of these good and glorious things that you and I both endorse.

Senator DOLE. I may want to keep you on after the next election.

Mr. LUBICK. I had better not make any reply to that one.

Senator DOLE. I have read the statement. I appreciate your views. However, it also seems to me there have been some rather serious charges leveled. Some speak about honest taxpayers and then about independent contractors.

I'm sure it is not your intent, to indicate that all those people out there who are of independent contractors are somehow evading, or avoiding, taxes. There may be an honest difference of opinion, at least, I hope that is not the intent of the statement.

Mr. LUBICK. The better word would be compliant.

Senator DOLE. As you understand, there is some strong feeling on both sides of this issue, I hope we can work out some satisfactory solution on S. 736. Do you also endorse S. 616?

That was the little technical bill that I put in.

Mr. LUBICK. Somehow we were not able to muster up the courage to endorse the bill, Senator.

I did not go into it in my oral presentation.

Senator DOLE. Your written statement indicates your reasons?

Mr. LUBICK. Yes, it does.

Senator DOLE. Thank you.

Senator BYRD. Senator Chafee?

Senator CHAFEE. I have no questions.

Senator BYRD. Thank you, Mr. Lubick, and gentlemen.

Mr. LUBICK. Thank you, Mr. Chairman.

[The prepared statement of Mr. Lubick follows:]

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STATEMENT OF
THE HONORABLE DONALD C. LUBICK
ASSISTANT SECRETARY OF THE TREASURY (TAX POLICY)
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and members of the Subcommittee:

My testimony today relates to seven bills: S. 224, S. 401, S. 616, S. 687, S. 736, S. 945 and S. 1514. I shall discuss each of these bills in some detail. But I would like to devote the bulk of my statement to the Administration's proposal for resolving the employee-independent contractor problem and to the alternative proposal contained in S. 736. This problem and its solution are of major importance to the integrity of our income and social security tax systems.

I. EMPLOYEES AND INDEPENDENT CONTRACTORS (S. 736)

Some workers bear more than their share of the income tax and social security tax burden. This is so because all workers are not treated alike for purposes of Federal payroll taxes and income tax withholding. The vast majority of the Nation's workers are employees who pay taxes on their compensation through regular withholding of a portion of their pay. Still, there is another large group of our workers who are outside the withholding system simply because they are classified as independent contractors under common law standards developed hundreds of years ago.

Substantial numbers of these so-called independent contractors do not pay their fair share of tax each year because they fail to report the full amount of their income. This noncompliance diminishes public respect for the operation of the tax system and jeopardizes our system of voluntary

compliance. Moreover, such conduct is patently unfair to honest taxpayers who must, as a result, bear a larger share of the tax burden.

In a recent study conducted by the Internal Revenue Service ("IRS") of compliance in reporting payments for services, at least 47 percent of workers treated as independent contractors did not report any of the compensation in question for income tax purposes. An even greater percentage, 62 percent, paid none of the social security tax due on their compensation.

Moreover, independent contractors bear less than their fair share of the social security tax burden even when they report all of their income. Although employees and independent contractors receive identical social security benefits, the social security taxes imposed on independent contractors under the Self-Employment Contributions Act (SECA) are lower than the social security taxes an employee must bear under the Federal Insurance Contributions Act (FICA). (Although one-half of the FICA tax is technically paid by the employer and one-half by the employee, in an economic sense the entire burden of this tax is borne by the employee.)

On the one hand, the opportunity for lower social security taxes and no withholding (accompanied by widespread noncompliance) constitutes a strong financial incentive for payors and workers to avoid "employer-employee" status. On the other hand, a primary goal of our tax system is to insure that everyone pays a fair share of the income and social security tax burden. These are the roots of the employee-independent contractor problem.

Summary of the Administration's Proposal

Prevention of large-scale noncompliance by independent contractors is a common goal of the Administration and the Congress. We believe that a system for withholding tax on compensation paid to independent contractors is the only effective way to achieve this goal.

We propose that a flat rate of 10 percent be withheld from payments made in the course of a trade or business for services provided by an independent contractor. Exceptions would permit individuals who work for five or more payors or who would be overwithheld to elect out of the system. The withheld taxes could be credited first to the worker's SECA

tax liability and second to his or her income tax liability. To complement this simplified withholding system, we are also proposing measures to strengthen the information reporting requirements of present law.

In addition, we believe that correcting the disparity between the FICA and SECA tax rates should be considered in the future as part of the broader issue of social security financing, and we would be pleased to work with the Congress to this end.

We also recommend a provision to ameliorate the financial impact upon payors whose workers are reclassified as employees. Under our proposal, in lieu of the payor's liability under present law for income and FICA taxes which should have been withheld, payors will be liable only for a penalty tax of 10 percent of the amount of wages not withheld upon. This penalty tax would be abated if it were reasonable for the payor to conclude that a worker was an independent contractor and the payor withheld a flat rate of 10 percent from the worker's compensation (or was excused from withholding because the worker elected out of the system).

We believe that our proposal addresses the major issues involved in the employee-independent contractor problem: the noncompliance by workers not subject to withholding, the FICA/SECA rate differential, and the burden of large liabilities in employment tax cases for withheld taxes. It is not, however, a one-sided proposal. While we have attempted to protect the Federal fisc, at the same time, we have tried to be responsive to the concerns voiced by taxpayers about so-called "retroactive" assessments and the importance of being an independent businessperson.

Now, I should like to discuss our specific proposals in some detail. Before doing so, however, I shall briefly review the IRS' independent contractor study and other evidence of noncompliance. A more detailed description of the independent contractor study is contained in the Appendix to my testimony.

Noncompliance

There is considerable evidence that the noncompliance among so-called independent contractors who are outside of our withholding system is unacceptably high. A specific IRS study of noncompliance by certain so-called independent contractors, a separate and more general IRS examination of the underreporting of income, and a report by the General

Accounting Office ("GAO") on persons who fail to file tax returns establish beyond a reasonable doubt that substantial numbers of persons who are currently outside our system of withholding are failing to report their income and bear their share of the tax burden.

The Independent Contractor Study. In order to provide a complete picture of compliance in this area, beginning in the fall of 1978 the IRS undertook a comprehensive study of income and social security tax compliance by workers treated as independent contractors. The study focused specifically on industries in which disputes between taxpayers and the IRS as to the employment status of workers have frequently arisen. To begin with, a list of the workers from all open examination cases involving the employee-independent contractor issue was obtained. A sample of more than 7,000 workers, representative of specific industries and occupations, was then randomly selected from this list. Next, the returns of those workers who could be located were fully audited by IRS agents.

Before going further, it is important to note that 21 percent of the workers in the sample could not be located. These workers were excluded in compiling our statistics on compliance. Noncompliance would be even greater if these workers were taken into account. Thus, our estimates of noncompliance are conservative.

The study does, in fact, demonstrate that there is widespread noncompliance by independent contractors. At least 47 percent of the workers reported absolutely none of the compensation in question for income tax purposes. This tax evasion clearly cannot be tolerated. Social security tax compliance was even worse. About 62 percent paid none of the social security tax due on their compensation.

A further finding was that noncompliance rates do not have much to do with the industry classification of the worker. Rather, the most important factors which explain noncompliance are the worker's income and the size of the payment for services. The greater the worker's income and the larger the amount of the compensation, the higher the compliance rate. This should not be interpreted to mean, however, that low compliance was confined to low paid workers. For example, over one-third of the workers with adjusted gross incomes of between $15,000 and $20,000 failed to report any of the compensation in question for income tax purposes, and over 50 percent of them failed to pay the social security tax due on such compensation.

At the request of the House Subcommittee on Select Revenue Measures, the GAO has reviewed the methodology and results of this study. Upon completion of its review, the GAO concluded that the results of the IRS study are accurate and indicate a serious compliance problem exists among the independent contractors examined in the study.

The revenue loss from this noncompliance is substantial. A conservative estimate of the annual revenue loss is $1 billion.

This widespread noncompliance not only deprives the Treasury and the social security system of revenues, but often deprives workers of social security coverage. The highest rates of noncompliance (and thus the greatest loss of social security coverage) are found among low paid workers, who are those most likely to need the protection afforded by social security benefits.

IRS Report on Unreported Income. On August 31, 1979, the IRS released a report on the underreporting of income entitled Estimates of Income Unreported on Individual Income Tax Returns. The report estimates that in 1976 individuals failed to report 6 to 8 percent of their income from legal sources, amounting to $75 to $100 billion.

The worst area of noncompliance uncovered by the IRS report was the failure of self-employed persons who are not subject to withholding to report the full amount of their income. The report estimated that between $33.0 and $39.5 billion of self-employment income was unreported for income tax purposes alone, reflecting an unacceptably high non-compliance rate for these persons of 40-46 percent. This amount was greater by far than the amount of omitted income from any other legal source.

GAO Report on Nonfilers. Similarly, a recent report by the GAO on taxpayers who do not file tax returns* underscores the fact that an undue portion of noncompliance is attributable to self-employed persons. The GAO report focused only on nonfilers and did not include income that is unreported by individuals who file tax returns, as did the IRS report on unreported income. Nevertheless, the GAO report showed that in 1972 self-employed workers accounted for 17 percent of all nonfilers, while the self-employed represented only 8 percent of taxpayers who filed returns.

* Who's Not Filing Income Tax Returns? IRS Needs Better Ways to Find Them and Collect Their Taxes, July 11, 1979 (GGD-79-69).

While many who oppose our withholding proposal may continue to deny that a compliance problem exists, the findings of the IRS study on independent contractors, the recent IRS report on unreported income, and the GAO report on nonfilers demonstrate beyond a reasonable doubt that substantial numbers of so-called independent contractors are failing to report the full amount of their income and pay their fair share of the tax burden. It is time for a responsible and effective legislative response. We believe that an expansion of the system of withholding which has served us so well in the past is the only effective way to combat this noncompliance. By taking this important step now, we can show the American people that we will simply not tolerate this tax evasion.

Withholding on Independent Contractors

At present, with some statutory exceptions, compensation is subject to withholding only if an employer-employee relationship exists under common law. In general, a worker is considered a common law employee if the person for whom the services are performed has control over the worker. Although the common law test has been used for many years, and works well in the vast majority of cases, in fact it has no direct relationship to whether workers should be subject to withholding. The technical legal distinction between "employees" and "independent-contractors" was developed in England centuries ago for purposes of determining those circumstances in which a master was liable for torts committed by his servants. For this purpose, the question of whether one person controls another was, and is, of primary importance. However, the presence or absence of "control" has little to do with whether a worker should be subject to withholding (or, for that matter, to higher premiums for social security benefits).

The most important consideration in developing a withholding system is to insure that the amount withheld approximates the amount of tax actually due. We believe that the common law works as well as it does only because it usually has the effect of implementing this more relevant policy consideration. In general, common law employees do not have substantial business expenses, so that the gross payments received by them approximate their income.

Instead of recommending that the existing system for withholding on employees at graduated rates be expanded in appropriate cases to cover independent contractors, we have

developed a simplified flat rate system for withholding which we believe will promote a high degree of compliance. However, if this simplified system is not successful in ending the unacceptably high rate of noncompliance among independent contractors we are willing to consider other alternatives, including an expansion of the system for graduated rate withholding on employees that has served us so well over the years.

Under our proposal, a flat rate of 10 percent would be withheld from payments made in the course of a payor's trade or business for services provided by certain independent contractors. To further simplify the system, an exception would help assure the existence of a continuing relationship between the payor and the worker. No withholding would be required on payments to an individual who normally provides similar services to five or more payors during each calendar year. A worker would be entitled to rely on this exception if he or she (1) performed similar services for five or more payors during the preceding calendar year, or (2) objective circumstances indicate that the worker can reasonably expect to perform services for five or more payors during the year in question.

Another exception would prevent overwithholding by permitting a worker who expected to owe less tax than the amount to be withheld (taking into account any taxes being withheld by other payors) to elect out of the system simply by checking a box and signing a form that would provide the payor with the worker's name, address and social security number that it is required to obtain for information reporting purposes under present law. A payor could also have a worker who claims to be exempt from withholding under the five payor exception so indicate on the same form. A payor who obtained this information would not be subject to any penalties for failure to withhold if it were subsequently determined that the worker should have been withheld upon as an independent contractor.

Flat rate withholding would also apply to salespersons whose compensation for services is based upon the difference between the price to them of merchandise sold and its resale price. Compensation, for purposes of withholding upon these workers, would be measured by the difference between the "suggested" selling price (or estimated, if there is no "suggested" price) to the customers for the products and the purchase price paid by the worker. Regulations would be

issued requiring appropriate arrangements to be made by the payor for the collection of the withholding tax. Similar requirements apply under present law for withholding income and social security taxes from employees, like agent-drivers, who are compensated in this manner.

Since the information necessary to implement a system for flat rate withholding on payments to independent contractors must be obtained by payors to comply with the information reporting requirements of present law (the worker's name, address and social security number), the additional costs associated with flat rate withholding should not be significant.

The feasibility of flat rate withholding on independent contractors is further evidenced by the fact that it has been supported by the federal tax division of the American Institute of Certified Public Accountants ("AICPA") in a July 23rd letter to the Subcommittee on Select Revenue Measures, as well as in recent testimony.

Flat rate withholding will also lessen the burden on the worker. Withholding is a simple and relatively painless way to pay taxes when compared to budgeting for large estimated tax payments.

Finally, our proposal will deal directly with a substantial segment of the unreported income outlined in the recent IRS report. Income unreported by independent contractors accounts for at least 20 percent, and possibly 30 percent or more, of unreported self-employment income, which that report found accounts for more than one-third of all unreported income from legal sources. Adoption of our withholding proposal is an important first step that Congress can take immediately to let the American public know that we do not intend to permit large numbers of taxpayers to escape paying their fair share of taxes in the future.

Strengthening the Information Reporting Requirements

For a number of reasons, information reporting can never replace withholding as a means of achieving satisfactory compliance. First, although much nonreporting is deliberate tax evasion, some of it is due to inadvertence, forgetfulness and failure by taxpayers to keep records. Any attempt to close the entire gap of unreported income by

means of information reporting and audit procedures would require millions of telephone calls, letters and visits, many involving small amounts of tax, which would almost inevitably be regarded as harassment of "little people." A drive of such proportions could generate taxpayer resentment so great as to seriously hamper the IRS' current enforcement efforts and jeopardize the very foundation of our system of voluntary compliance. Second, the cost of following up the millions of apparent discrepancies in the reporting of compensation would be demonstrably uneconomical. Such an unbalanced enforcement effort could not be reconciled with any sound concept of tax administration. Third, even extensive pursuit of taxpayers would not achieve full collection of unpaid taxes. As demonstrated by the IRS independent contractor study, there would be many unfruitful investigations where taxpayers cannot be reached by telephone or traced if they have moved. Even after the taxes have been assessed, it may be impossible or uneconomic to collect them.

For these reasons, as well as others, we believe a system for withholding on independent contractors is preferable to a system of reporting, matching and enforcement. On the other hand, since a number of workers still will not be subject to withholding it is necessary to complement the withholding system with an effective information reporting system. Consequently, we propose three measures designed to strengthen the information reporting requirements of present law.

First, we recommend that penalties for failure to file information returns be increased to 5 percent of payments not reported, with a minimum penalty of $50. The penalties under present law for failure to file information returns of $1.00 per failure to file a return, with a maximum penalty per calendar year of $1,000, are inadequate. The IRS estimates that fewer than 60 percent of the required information returns for nonemployee compensation are actually filed.

Second, to remind independent contractors of items of income not subject to withholding when preparing their tax returns, we propose that payors be required to provide copies of information returns to workers. Penalties for failure to provide these copies would be the same as for failure to file the returns.

Finally, information reporting should be extended to compensation for services performed by salespersons based upon the difference between the cost and selling price of goods sold.

Revenue Estimates

Our proposals for withholding and strengthened information reporting will result in a significant increase in compliance in the reporting of income by self-employed workers. A conservative estimate of the annual revenue gain is $600 million.

Differences in Social Security Tax Burdens

Although not central to the issue of compliance, in considering this question it is important to bear in mind the effect of the differing social security tax rates for employees and the self-employed.

FICA taxes are paid at a higher rate than SECA taxes on the same amount of compensation -- currently the first $22,900 of earnings. (Moreover, earnings subject to tax under FICA are gross wages, and earnings subject to tax under SECA are net income.) Under FICA, the employee is taxed at a rate of 6.13 percent, and the employer is taxed at the same rate. Thus, the combined employer-employee tax rate under FICA is 12.26 percent. In contrast, the self-employed pay SECA taxes at a rate of only 8.1 percent. In 1981, the combined FICA tax will rise to 13.30 percent, compared to a SECA rate of only 9.30 percent.

Despite these different tax rates, both employees and the self-employed are entitled to the same social security benefits. The self-employed do not receive less Medicare coverage or lower retirement or disability benefits than those who worked as employees.

Although technically the burden of the FICA tax is shared by employer and employee, in an economic sense, the entire burden is borne by the employee. In calculating the costs of labor, an employer includes not only payments made directly to employees or which are credited to their account, but also any payroll tax payments that the employer must make as a result of hiring the employee. Economists are almost universally agreed that the wage the employee receives is lower than it would be in the absence of the payroll tax. In effect, the employee pays the employer share of the payroll tax in the form of lower gross wages. The fact that employees may exclude from their income the amount of social security taxes paid on their behalf by employers in effect narrows the difference between the FICA and SECA tax rates, but only partially.

The very fact of a lower tax rate on the self-employed may cause distortions in work decisions. This is true regardless of whether there are compliance problems, although the lack of compliance by independent contractors certainly exacerbates the situation. Even when an employer-employee relationship is more appropriate and the better alternative on all other grounds, the fact of the higher FICA tax rates can make independent contractor status more attractive for both parties.

It would be possible to reduce the tax advantages inherent in independent contractor status by a combination of more nearly equal social security tax rates and tax deductions for income tax purposes. Such changes could make the decision as to whether to become an independent contractor or an employee more neutral and relieve much of the pressure on the question of employment status. These changes would also have the effect of increasing revenues to the social security and medicare trust funds.

We believe correcting the disparity between the FICA and SECA tax rates should be given consideration in the future as part of the broader issue of social security financing, and we would be pleased to work with the Congress to this end.

Substitution of a 10 Percent Penalty Tax for Employer's Withholding Tax Liability

Under present law, when workers who were treated as independent contractors are reclassified as employees, in addition to their own liability for FICA and FUTA taxes, payors are liable for all income and FICA taxes which should have been withheld from workers. This withholding tax liability has been a major aggravation in employment tax disputes. Although the liability for income taxes not withheld may be abated if the payor furnishes evidence that the workers paid the proper amount of tax, often such evidence cannot be obtained, or when it can the burden of doing so is time consuming and costly. Furthermore, the liability for FICA taxes not withheld cannot be abated unless the worker paid SECA taxes and is prevented by the statute of limitations from claiming a refund of the erroneously paid SECA taxes.

To eliminate the problems associated with the payor's withholding tax liability, we propose substituting for this liability a penalty tax equal to 10 percent of the amount of

wages not withheld upon. Payors whose workers are reclassified as employees would remain liable for the employer's half of FICA taxes and FUTA taxes. The worker would be liable for the employee's half of FICA taxes.

Furthermore, if it were not unreasonable for the payor to treat the worker as an independent contractor and the payor also withheld a flat rate of 10 percent from the worker's compensation (or was excused from withholding because the worker elected out of the system), the 10 percent penalty tax would be abated and the payor would only be liable for its own share of FICA taxes and for FUTA taxes.

The 10 percent penalty tax would both reduce the employer's potential withholding liability and eliminate entirely the costly and burdensome need for employers and the IRS to determine whether the worker paid income or SECA taxes, in order to abate any of the payor's withholding tax liability.

Additional Considerations

We recognize that under the proposed system for flat rate withholding it still will be necessary for a business to rely on common law standards to decide whether to withhold at a flat rate (on independent contractors) or at a graduated rate (on employees) and pay the employer's share of FICA and FUTA, and that the lack of clarity inherent in these standards has been responsible in part for some of the problems in this area in the past. However, extending flat rate withholding to independent contractors will lower the stakes that turn on this definition for both taxpayers and the government, and therefore the number of disputes involving employment status should be reduced. Substituting a penalty for the large assessments against payors whose workers are reclassified as employees should further relieve the pressure on the common law definition of employment status. Moreover, if the inequality in FICA and SECA taxes were also eliminated, the remaining pressure on the common law test would be removed and disputes as to employment status for income and social security tax purposes should largely disappear.

Nevertheless, if absolute certainty is considered paramount, objective standards to supplement the common law and assist payors in making determinations of withholding status could be provided as part of a flat rate withholding system. However, we strongly urge that any such criteria provide certainty by erring only on the side of classifying

workers as subject to graduated rate withholding; in no event should any new test allow workers who unquestionably are common law employees to escape graduated withholding and be treated as independent contractors. We must not in an effort to provide certainty also increase the number of workers who are outside of the graduated rate withholding system that has worked so well over the years. Of course, absent flat rate withholding on independent contractors, a test that placed more workers outside of any withholding system would be highly objectionable in light of the high rates of noncompliance for independent contractors. In addition, any test that would permit workers who are widely recognized as employees under present law to be reclassified as independent contractors could result in depriving them of many of the protections upon which they depend, such as state unemployment compensation coverage.

Alternative Solutions

Instead of a simplified flat rate system for withholding on independent contractors, another effective way to combat noncompliance would be to replace the common law test and require graduated rate withholding on all workers paid other than on a wage or salary basis, unless the gross payments received by a worker would not approximate his or her net income and it is likely the worker would provide services to multiple payors.

For example, graduated rate withholding could be required on compensation paid to these workers unless a worker had (1) a separate place of business (other than a home office), (2) a substantial investment in assets (other than transportation vehicles used in a nontransportation business), (3) employees of his or her own who provided a substantial portion of the services for which compensation is received, or (4) substantial, continuing expenses and concurrently performed services for more than one payor.

Such a system would effectively combat noncompliance by extending withholding to cases in which withholding of income taxes is appropriate. In addition, because of the economic dependence that would exist between payors and workers covered by withholding under these criteria, inclusion of these workers within the group of workers subject to FICA would be appropriate. Indeed, if flat rate withholding is not adopted, the noncompliance problem can only be solved by this or a similar alternative.

Finally, I would like to comment on S. 736. In light of the demonstrably high rate of noncompliance among workers not subject to withholding, we oppose S. 736 because it moves our tax system in precisely the wrong direction by placing an increasing number of workers outside our existing system of withholding.

In essence, S. 736 would provide a safe harbor test for independent contractor status. Under the bill, a worker could be treated as an independent contractor if the following five requirements were met: (1) the worker controls the aggregate number of hours worked and substantially all the scheduling of the hours worked; (2) the worker does not maintain a principal place of business or maintains a principal place of business which is either not provided by the payor or is rented from the payor; (3) the worker has a substantial investment in assets used in connection with the performance of services or risks income fluctuation in that his or her remuneration is directly related to sales or other output rather than the number of hours worked; (4) the worker (a) performs services pursuant to a written contract which was entered before the performance of services and which provides that the worker will not be treated as an employee for FICA, FUTA and income tax withholding purposes, and (b) is provided written notice in such contract or at the time of the contract of his or her responsibility with respect to the payment of self-employment and Federal income taxes; and (5) the payor files information returns required in respect of such service under Code section 6041(a).

First, it is noteworthy that S. 736 would permit workers in all of the industries in which there have been disputes as to employment status -- and in which the IRS study demonstrates high rates of noncompliance -- to be treated as independent contractors.

Second, the bill would go beyond its stated purpose of clarifying the distinction between employees and independent contractors by permitting workers whose status as employees is well established to be treated as independent contractors. For example, long-standing employer-employee relationships could be manipulated quite easily to meet the requirements in S. 736. Employees whom payors might attempt to classify as independent contractors would include any type of repairperson (for instance, someone who works for a gas, electric, or appliance company), piece workers and agricultural workers. Loss of status as an employee for some of these workers could also mean loss of state unemployment compensation coverage.

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Third, the five-factor test in S. 736 is fairly complex to apply. Innumerable new questions will be raised about what constitutes "control of hours," "rental" of a "principal place of business," a "substantial investment in assets" or "income fluctuation."

We simply cannot afford legislation like S. 736 which would increase the opportunities for tax evasion by placing more workers outside our system of withholding and add significantly to the estimated revenue loss under present law of at least $1 billion.

Conclusion

As the members of the Subcommittee consider this problem in the next few weeks, we are certain you will realize that there is no easy solution to this problem. A choice must be made between flat rate withholding on independent contractors, expanding our system of graduated rate withholding in cases where it would be appropriate to do so, or continuing to permit a great many taxpayers to avoid paying taxes.

Withholding is the cornerstone of our tax system. Withholding benefits not only the government, but also taxpayers by providing them with a gradual and systematic way to pay their taxes and insuring that they receive social security coverage. The thrust of our proposal is to expand this tried and true method of collecting taxes where it makes good sense and where there is good reason for doing so.

High noncompliance by independent contractors who are outside of our system of withholding has been proven to exist. The time has come to provide the American people with a responsible and effective legislative response. We believe that our proposal for flat rate withholding on independent contractors is responsive to the concerns of both the Government and taxpayers. We urge its adoption.

II. FRINGE BENEFITS (S. 224)

S. 224 is designed to prohibit permanently the issuance of income tax regulations relating to fringe benefits. This bill would not only extend indefinitely a regulations moratorium now scheduled to expire December 31, 1979, but would also expand the scope of the moratorium to preclude even the issuance of proposed regulations for public comment. We oppose its adoption.

The bill does not affect the substantive statutory rules governing taxation of fringe benefits. The Internal Revenue Code defines "gross income" broadly, subject to specific statutory exemptions for such employee benefits as pensions and health insurance plans. When called upon to interpret the Code language, courts have almost invariably held that compensation furnished by an employer "in kind" is taxable.

Few persons quarrel with the general principle of fringe benefit taxation reflected in the Code. Our tax system could not remain viable if the tax base were limited to cash transactions. The obvious result of a wholesale tax exemption would be the creation of a potent inducement for non-cash forms of compensation. The impact on taxpayer equity would be severe; individuals with similar economic incomes could have vastly different tax liabilities, depending upon the particular form of employee compensation. And Government revenues would be eroded significantly unless tax rates were raised even higher on cash wages.

There is also a consensus that implementation of the general fringe benefit tax principles must be tempered by practical considerations. Noncompensatory business purposes of the employer should be recognized. Taxpayers should not be expected to account for items of small value. IRS resources should not be expended to collect taxes on inconsequential employee benefits.

Yet, in spite of this general agreement on the objectives of fringe benefit taxation, administration of the law in this area has been unsatisfactory. Application of the principles to real life situations has resulted in disturbing inconsistencies, with treatment of individual taxpayers varying widely across the country. Some of the problems are attributable to apparent conflicts in published IRS positions through the years. Other problems result from the paucity of national guidance on critical administrative issues; taxation is determined in large part by the particular views of local IRS agents.

S. 224 would preserve this disarray. Its enactment would bar any efforts to develop a more rational, evenhanded approach to administration of fringe benefit taxation. Current fringe benefits would remain subject to inconsistent treatment, and the IRS would be unable to respond sensibly in the future to new fringe benefit practices and to other changes in circumstances. The net result would be to compound the confusion for employers, employees and IRS agents.

We recognize the need for time to consider the fringe benefit issue. Congress should have ample opportunity to determine whether, and to what extent, a Code amendment is needed. For our part, we can assure you that any fringe benefit regulation representing significant departures from current administrative practices would not become effective until the public and Congress had sufficient time to review the details of any such proposal. Accordingly, any extension of the current legislative moratorium on fringe benefit regulations is unnecessary. A permanent prohibition, as set forth in S. 224, is devastating; it would forfeit any opportunity to reach a satisfactory resolution of the basic tax problem.

Mr. Chairman, in concluding my remarks on this bill, let me mention a disturbing trend in tax legislation -- a trend of which S. 224 is a part. During the past two years, Congress has favorably considered a number of measures designed to prohibit tax administration in specified areas. One-year moratoria were enacted in 1978 with respect to the fringe benefits and independent contractor issues. Even more disturbing is the 1979 attempt to use appropriations bills to prohibit certain IRS enforcement efforts.

Without a doubt, the tax questions involved in these areas are exceedingly difficult and controversial. The administrative approach must quite properly be guided by the substantive decisions on tax policy made by Congress. But severe problems arise if there is no means to answer the questions of taxpayers and revenue agents about specific cases. The tax system fails when Congress has neither provided legislative answers nor permitted the IRS to provide national guidance as to the administration of existing law. We hope that the Subcommittee will reject S. 224 and other efforts to use this type of Congressional response to tax issues.

III. TERMINATION OF WAIVER OF SOCIAL SECURITY TAX EXEMPTION (S. 401)

In general, employees of tax-exempt organizations described in section 501(c)(3) of the Internal Revenue Code are not covered under the social security program. A section 501(c)(3) organization may obtain this coverage for its employees by filing Form SS-15, Certificate Waiving Exemption from Taxes Under the Federal Insurance Contributions Act, together with Form SS-15a, containing the names of employees

who concur in the filing. Individuals who are employees at the time Form SS-15 is filed have an option of electing coverage by signing the Form SS-15a or by signing a Form SS-15a Supplement within 24 months of the date the Form SS-15 is filed. Individuals who are hired after the quarter in which the Form SS-15 is filed are automatically covered under the Form SS-15.

Once the certificate has been filed and is effective, it remains effective for all future years unless a request for termination is made. Such request may not be made unless the certificate has been in effect for at least 8 years. Then the election may be terminated, with 2 years advance notice.

S. 401 is concerned with the application of these waiver rules in the case of the Manhattan Bowery Corporation. Several errors gave rise to difficulties for the Corporation. First, the Corporation incorrectly believed that it had not filed Forms SS-15 and SS-15a electing FICA coverage prior to 1975, even though it had routinely paid the employer's share and collected and paid the employees' portion of the FICA taxes. Based on this erroneous belief, it elected coverage in 1975 and filed for a refund of social security taxes for those employees not electing FICA coverage. The Corporation had, in fact, filed a previous waiver in 1968. Second, the Internal Revenue Service relied on the information provided by the Corporation without making certain a previous waiver had not been filed and incorrectly granted the requested refund. Third, the Corporation, being unaware of its previous waiver, did not collect the employees' share or pay the employer's share of social security taxes on the employees not concurring in the 1975 waiver.

S. 401 would relieve the Corporation of any liability to repay the employees' portion of FICA taxes with respect to employees who had elected in 1975 not to be covered by social security, with respect to wages paid prior to the filing of the erroneous waiver in 1975. In addition, the Corporation is relieved of such liability with respect to taxes on wages paid after the filing of the waiver and prior to July 1, 1977 to individuals no longer employees on July 1, 1978, if such taxes were not withheld. The wages with respect to which the liabilities are forgiven would not constitute wages for purposes of social security benefits, unless the employee qualified for benefits prior to enactment of S. 401. The Corporation is not relieved of liability for the employer's portion of the taxes, but is relieved of interest or penalties on such taxes with respect to wages paid prior to July 1, 1978.

In view of the Corporation's equitable basis for relief on the facts, the Treasury Department does not oppose enactment of S. 401. However, certain technical amendments are suggested. First, subsection (b)(3)(A) should be revised. As now drafted, that subsection would include, for social security benefit purposes, the wages on which liabilities are forgiven as long as an individual enters into an agreement with the Secretary of the Treasury to pay an amount equal to the forgiven liabilities. The bill should explicitly require that such an amount actually be paid to the Treasury before the benefit credit becomes applicable.

Second, in regard to these individual payments, the Treasury Department does not feel that the rulemaking procedure should be employed to deal with such a relatively small group of employees of a single employer; the Secretary should simply be directed to prescribe the manner of effecting payment without reference to the regulatory process.

Third, since the Corporation became aware in April 1977 that a waiver was filed in 1968, and since the Corporation knew by the end of 1977 that it should be collecting and paying social security taxes on employees who had not concurred in the 1975 waiver, the bill should provide that no interest or penalty is due with respect to such wages paid by the Corporation "prior to January 1, 1978" rather than "prior to July 1, 1978" as subsection (a)(2)(B) now provides.

Fourth, the bill needs to be clarified so that references to the Secretary of the Treasury refer instead to the Secretary of the Treasury or his delegate.

The determination of an individual's benefits under the Social Security Act is within the jurisdiction of the Department of Health, Education and Welfare. Accordingly, the Treasury Department expresses no opinion with respect to those provisions of the bill that concern an individual's benefits under the Social Security Act.

IV. CERTAIN CONTRIBUTIONS TO FRATERNAL ORGANIZATIONS (S. 616)

Code sections 170, 2055 and 2522 allow a deduction for income, estate and gift tax purposes for contributions or gifts to a domestic fraternal organization, operating under the lodge system, only if the contribution is used exclusively for charitable purposes. Under the bill, a deduction would

be allowed for Federal income, estate and gift tax purposes for a contribution or gift to a tax-exempt domestic fraternal organization for the construction or maintenance of a building the principal purpose of which is to house the organization. Since tax-exempt domestic fraternal organizations engage in both fraternal and charitable activities, S. 616 would permit a deduction for certain contributions to these organizations that are not used exclusively for charitable purposes.

Under present law domestic fraternal organizations already receive special treatment by virtue of the allowance of a deduction for income, gift and estate tax purposes for contributions that are used exclusively for charitable purposes, even though these organizations themselves are not organized and operated exclusively for charitable purposes. By contrast, a deduction is generally allowed only for a charitable contribution to an organization organized and operated solely for charitable purposes. We believe that the deduction for contributions to domestic fraternal organizations should be limited, as under present law, to contributions that are used exclusively for charitable purposes; therefore, we oppose the expansion of Code sections 170, 2055 and 2522 as proposed by S. 616. There is no reason to allow a charitable contribution for funds used to construct a building used for fraternal purposes.

V. RHODE ISLAND INDIAN CLAIMS SETTLEMENT (S. 687)

The purpose of S. 687 is to finalize implementation of a settlement agreement among the Narragansett Indian Tribe, the State of Rhode Island and private landholders in Charlestown, Rhode Island, concerning the Tribe's claims to certain land within the town of Charlestown and for damages for trespass on such lands. The major part of the implementing legislation was passed by the Congress and signed into law by the President on September 30, 1978, as the Rhode Island Indian Land Claims Settlement Act of 1978 (the "1978 Settlement Act"), P.L. 95-395. The present amendment to the 1978 Settlement Act restores two sections of the original bill (H.R. 12860), pertaining to taxation, which were eliminated by mutual agreement of all affected parties solely to expedite passage in the brief time which remained in the 95th Congress after consideration of the legislation in 1978.

The first part of the bill would provide a limited tax exemption to the quasi-public State Corporation which, as specified in the 1978 Settlement Act, would receive, hold and manage the settlement lands.

The second part provides for special tax treatment for private landholders who have agreed to sell their land to facilitate the settlement. This treatment would allow them to defer paying taxes on the profit they realize from the sale of their land, as long as this money is reinvested in a similar asset.

The legislative solution set forth in the 1978 Settlement Act was based in part on a finding that the Narragansetts had presented a credible claim to the lands involved. Moreover, it was recognized "that the mere pendency of Indian claims may result in severe economic hardships from the clouding of land titles and that it is proper for the Federal Government to aid the States in settling legitimate Indian claims." H. Rep. No. 95-1453, pp. 7-8.

Under Code section 1033, gain can be deferred in certain instances where condemnation or the threat of condemnation has resulted in the involuntary conversion of a property holding into a similar property holding. The private landholders argue that providing them with section 1033 deferral is proper, because the facts and circumstances are within the statutory policy governing "involuntary conversions." They say that since the Federal Government determined that the "credible claim" of the Narragansetts justified a legislative settlement, then sale of their land has, in effect, been compelled for a valid public purpose. The sales are viewed as being closely akin to a public taking.

The 1978 Settlement Act was a response to a unique set of factual and legal circumstances. We understand that the 1978 Settlement Act, and the present amendment thereto, are not intended to serve as a precedent for the proper Federal treatment of different Indian land claims in other parts of the country. Each such claim must obviously be evaluated on its own particular facts and circumstances.

In view of this background, the Treasury Department does not oppose the bill. We would suggest, however, that the language in the bill exempting moneys to be received by the state corporation from the Federal Government be deleted because it is not needed. Although it was at one time contemplated that moneys might be so received, the 1978 Settlement Act does not provide for any such payments.

VI. CERTAIN EMPLOYEE ANNUITIES (S. 945)

Under current law, an employee of a tax-exempt organization described in section 501(c)(3) of the Code, or an employee of a public school system, may participate in a tax-exempt salary reduction annuity plan. In general, employer contributions for the purchase of an annuity contract under such a plan are excludable from the employee's gross income and are not subject to tax until the employee receives payments under the annuity.

S. 945 would extend the availability of these tax-exempt salary reduction annuity contracts to the civilian faculty and staff of the Uniformed Services University of the Health Sciences. It is our understanding that the bill is intended to allow the Uniformed Services University of the Health Sciences to attract civilian faculty and staff by offering retirement benefits and salary reduction plans similar to those given to the faculty and staff of medical schools which are tax exempt under section 501(c)(3) or which are part of a public school system.

S. 945 is substantially identical to H.R. 12606, which was introduced in the 95th Congress. As we testified before the Subcommittee on Miscellaneous Revenue Measures of the Committee on Ways and Means on June 14, 1978 with respect to H.R. 12606, the Treasury Department does not believe that section 403(b) represents sound tax policy. However, in the context of the present law, the Treasury did not oppose H.R. 12606 and does not oppose S. 945.

We do suggest a change in the effective date of the bill. S. 945 provides, as did H.R. 12606, that it will apply to services performed after December 31, 1977, in taxable years ending after such date. We do not believe it is appropriate to provide for a retroactive effective date, and we urge revising S. 945 to provide that it would be effective with respect to services performed after the date of enactment in taxable years ending after such date.

VII. SOLID WASTE DIPOSAL FACILITY INDUSTRIAL DEVELOPMENT BONDS (S. 1514)

Under section 103(b) of the Code, interest on industrial development bonds is generally taxable. An exception is allowed, however, for bonds which provide solid waste disposal

facilities. S. 1514 would amend this exception in two ways. First, it would expand significantly the definition of a solid waste disposal facility eligible for tax-exempt financing. Second, it would permit bonds issued to provide qualifying solid waste disposal facilities to be tax-exempt notwithstanding the fact that such bonds are federally-backed.

Expansion of Qualifying Faciliites

S. 1514 provides that solid waste disposal facilities include

> "any facility, operated by or on behalf of the governmental unit, which has the function of producing gas, heat, or energy directly or indirectly from the solid waste disposal process and which is located at the same place as, or adjacent to, a solid waste disposal facility."

This provision would include as a solid waste disposal facility eligible for tax-exempt financing any facility which produces gas, heat, or energy from the disposal process and which is located in close proximity to the solid waste disposal facility. It is our understanding that this part of the amendment is directed primarily at facilities which generate electricity using solid wastes as fuel.

We are opposed to expanding the definition of qualifying solid waste disposal facilities. The use of tax-exempt bonds to finance solid waste disposal facilities is neither a desirable nor efficient means of subsidizing solid waste disposal. Subsidies provided through tax-exempt financing are highly inefficient. It takes considerably more than $1 of federal revenues in order to provide $1 of subsidy with tax-exempt bonds since, among other reasons, the costs of using tax-exempt bonds as a subsidy mechanism include substantial transfers to wealthy taxpayers. Thus, even if we assume that the facilities described in S. 1514 deserve a federal subsidy, tax-exempt bonds are almost certainly one of the least efficient means to deliver that subsidy.

Moreover, we believe that before any federal subsidy is provided, a strong case must be made for federal intervention. While we take no position on the merits of integrating energy production with solid waste disposal, we would urge the Committee to evaluate carefully whether such process is desirable, and, if so, whether any federal program is needed.

If the Committee agrees that a federal program to assist this form of energy production is needed, there are, of course, a great variety of means to do so. For example, what in fact is being proposed here is a form of interest subsidy. If the Committee were to decide that an interest subsidy is appropriate, there are methods of delivering that subsidy at far less cost to the federal government than by issuing tax-exempt bonds. In fact, Congress has on a number of occasions provided for low-interest Federal loans or direct Federal interest subsidies on taxable municipal bonds for various housing, transportation, community facilities and other programs.

S. 1514 also provides that "any facility which has the function of recovering material from solid wastes" will be a solid waste disposal facility eligible for tax-exempt financing. If read expansively, this provision could include as a solid waste disposal facility any integrated manufacturing process which includes solid waste as an input at any stage, since, taken literally, such facility would have the function of recovering material from solid wastes. We assume, however, that S. 1514 does not contemplate an expansion of tax-exempt financing to so broad a category of property. Consequently, it is our assumption that this provision is intended merely as a codification of the applicable regulations since the regulations now permit tax-exempt financing of facilities used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. (For this purpose, solid waste must have no market or other value at the place where it is located.) If this is the objective, a statutory change would appear to be unnecessary.

Federal Guarantee

S. 1514 would also provide that interest on bonds issued to finance a solid waste disposal facility will remain tax exempt even though the credit underlying those bonds is that of the federal government. In other words, this part of the bill supports the use of federally-backed tax-exempt bonds to finance solid waste disposal facilities.

Although the federal guarantee provided by S. 1514 is indirect, it is no less real or effective than a direct federal guarantee. The bill would allow tax-exempt financing for a solid waste disposal facility where that facility or its output is used by the U.S. Government, and the payments made by the U.S. Government are pledged to secure the bonds and actually used to repay principal or interest. This

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would occur, for example, where the U.S. Government (or any of its agencies or instrumentalities) enters into a long-term contract to purchase all or a substantial portion of the output of the facility. Once that contract is signed and then incorporated as security for the bonds, a potential purchaser of the bonds is relying on the credit of the U.S. Government to secure the payment of principal and interest. This arrangement is indistinguishable economically from a situation in which the U. S. Government directly guarantees the loan.

It is generally recognized that tax exemption of municipal bonds is an inefficient means of public financing because the revenue loss to the Treasury substantially exceeds the interest savings of the municipal borrower. Consequently, it is far more efficient to finance federal programs with taxable bonds. Accordingly, the Public Debt Act of 1941 prohibits the exemption of interest on Treasury or federal agency debt from federal income taxes. Consistent with the spirit of that Act, Congress has generally determined in recent years that federal guarantees should not be used to finance federal programs indirectly with tax-exempt bonds. In fact, on no less than 19 occasions since 1970, Congress has adopted statutes which prohibit federal guarantees of tax-exempt obligations.

Congress has rejected the combination of a tax exemption and a federal guarantee even in the case where the financial survival of a major city was at stake. In the New York City Financial Assistance Act, Congress determined that it was inappropriate to provide both tax exemption and a federal guarantee.

Federally-backed tax-exempt obligations pose major problems for federal debt management. Combining tax exemption with a federal guarantee creates an obligation which is superior to obligations the United States may issue itself. Consequently, Treasury has consistently opposed creating such obligations since their proliferation could seriously interfere with the marketing of U.S. Government debt obligations, particularly if the practice became widespread.

Federally-backed tax-exempt bonds also threaten the municipal bond market. They are superior to all other state and local government bonds because they are virtually risk-free. If such bonds become widespread, they will tend to increase muncipal interest rates and to crowd out conventional tax-exempt bonds designed to finance roads, schools, municipal buildings, and other essential public projects.

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Finally, specifically authorizing indirect federal guarantees of tax-exempt bonds will further impede efforts to control federal credit programs. Such control is vital, but nonetheless difficult to achieve, even where direct federal guarantees are present. As federal commitments become more difficult to trace, it becomes increasingly difficult for the federal government to manage its budget. It makes little sense for the government to be striving to improve federal credit control and, at the same time, making it more difficult to achieve such control.

For the reasons set forth above, Treasury opposes S. 1514.

Appendix

IRS Employee/Independent Contractor Compliance Study

The objective of the 1979 Internal Revenue Service Employee/Independent Contractor Compliance Study (the Study) was to determine the extent to which workers who the IRS believed were employees (but who had been treated by their payors as independent contractors) were actually reporting their compensation for income tax and for social security tax purposes. Basically, the Study was performed by tracing a sample of payments from payor records to the income tax returns of the workers. Workers were audited in order to determine whether they had received the payments and whether all, a portion, or none of the payments had been reported on their income tax returns.

Summary Conclusions from the Study

The data from the Study show income and social security tax compliance rates in terms of both compensation received and numbers of workers, as classified by the workers' incomes, by the amounts of the payments, by the industry of the payor, by the occupation of the worker, and by several other classifications. The data show varying compliance rates between the various categories. The Office of Tax Analysis of the Treasury Department has made an attempt to analyze the causes and the significance of these varying compliance rates. While this analysis is still in its early stages, several conclusions can be drawn.

- Approximately 47 percent of all workers who are treated by payors as independent contractors do not report any of their compensation. Another 5 percent report some of their compensation. Only 48 percent report all of their compensation.

- Only 76.2 percent of all payments are reported for income tax purposes, resulting in a noncompliance rate of 23.8 percent.

- There is a significant, positive correlation between the size of compensation payments and the compliance rate: the larger the compensation payment, the higher the probability that it will be reported. There are indications that for each

additional $1,000 of compensation received, the compliance rate increases by about one-half of one percentage point.

- The compliance rate also increases with adjusted gross income (or adjusted gross income less income from compensation payments). For each additional $1,000 of income other than compensation payments, the compliance rate increases by about 0.2 percentage points.

- A large proportion of the variation in compliance rates between industry and occupation categories is accounted for by the distributions of the sizes of the compensation payments and of the workers' adjusted gross incomes within a particular industry or occupation category.

- Most workers either fully report their income or report none of it. Roughly, 50 percent of workers receiving about 70 percent of the total payments fully report their incomes. Another 5 percent with between 5 and 10 percent of the payments report part of their compensation, with most reporting over 80 percent. The remaining 45 percent of all workers (with 20 to 25 percent of total payments) report absolutely none of their compensation.

- Reporting for social security purposes is lower than for income tax purposes. This difference may be largely explained by the amount of payments reported as "wages and salaries" and as "other income" rather than as business receipts.

Tables and Charts from the Study

This appendix contains 13 tables from the Study which summarize its findings in regard to compliance rates.

Tables 1 through 4 summarize income reporting and social security tax compliance rates by size of the compensation payments to the worker, by income class, by the payor's industry, and by the worker's occupation. These tables show the proportion of income reported for income tax purposes, the proportion of SECA tax liability shown on the return, and

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the proportion of workers fully reporting, partially reporting, and not reporting for both income tax and SECA purposes.

Charts 1, 2, and 3 show the proportion of workers who did not report any of their compensation for income tax purposes, classified by the size of the compensation payments, by adjusted gross income, and by the industry of the payor.

Tables 5 through 8 show reporting for income tax purposes as to both the proportion of workers reporting and the amounts of compensation reported. Data are shown for full reporters, partial reporters (underreporters), and nonreporters. There are separate tables showing the data by amount of compensation, adjusted gross income, industry of the payor, and occupation of the worker.

Table 9 shows compliance rates in terms of the percentage of payments reported cross-classified by industry and occupation.

Tables 10 through 13 show social security tax compliance rates for the same four classifications as in Tables 1 through 4. Compliance rates are in terms of the proportion of proper social security tax actually paid and the proportion of workers who paid at least some of their social security tax. The tax compliance rates are shown in two ways. The compliance rate in the first column is based on the social security treatment of compensation as shown on the worker's tax return. If the worker reported the income as income from a business, it was treated as subject to SECA tax. If the worker reported the income as wages or salary, it was treated as subject to the employee's share of FICA tax. The compliance rate in the second column is based on the assumption that all payments were business income and, hence, subject to SECA tax.

Methodology

The Study attempted to measure the extent to which payments known to have been made were actually reported for both income tax and social security tax purposes.

As part of its regular audit program, the Internal Revenue Service audits employers for compliance with the income tax and social security tax (FICA) withholding provisions. These audits attempt to verify that the proper

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amounts have been withheld from employees (and, as applicable, matched by employers) and paid to the IRS. Attempts are also made to determine whether payments to persons who are not treated by the employer as employees (i.e. those treated as independent contractors) should actually have been treated as payments to employees. The sample for this Study was drawn from a list of payments which the IRS had proposed to reclassify from payments to independent contractors to payments to employees.

Late in 1978, all such "open" audit reclassifications for tax years 1976 and 1977 were collected. From these cases, a stratified random sample was selected from those which contained sufficient information to provide a reasonable possibility of follow-through. The selection process was random except for stratification to provide a sufficiently large sample in various occupation and industry categories.

The selected sample consisted of payments by 2,600 employers to 7,109 individuals. Attempts were made to locate and contact these workers, to locate their tax returns, and to obtain tax returns from those who had not already filed them. As Table 14 shows, 5,152 (72.5 percent) of the workers with 89.9 percent of the compensation reportedly paid were located and audited. The remainder were not audited for various reasons, predominantly because the payor records contained incorrect information or did not contain sufficient information to locate the workers. Attempts to locate these individuals were abandoned only after the IRS had expended considerable efforts and it had been determined that additional efforts would not have been fruitful. About 5 percent of workers with 1 percent of the compensation were not audited because it was determined that their total income level was below both the income tax and the self-employment filing requirements, so that there would be no tax consequences stemming from the payments involved.

For each worker whose return was audited, an audit checksheet was completed (see Attachment I) which showed the amounts of compensation received by the worker and the amount initially reported on the tax return, both for income and social security tax purposes. Information on the tax consequences of the compensation was also included. The form also contained additional information about the income and taxes of the worker, about the payor's industry and worker's occupation (as defined by both the payor and the worker), the

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payor's size, the worker's geographic region, etc. An additional form indicating the size of the payor was also completed (see Attachment II) and associated with each worker's record.

For purposes of analyzing the results of the Study, the information from these two forms for each audited worker has been processed into tables which show the results in the aggregate and for various subgroups according to several different classifications and cross-classifications. The tables represent simple tabulations of the raw data. No attempt has been made to weight industry, occupation, and income groups to represent their relative frequencies in the population because the tests of weighting which have been performed indicate that weighted data would not differ materially from unweighted data.

The most important conclusions in terms of compliance rates are summarized in Tables 5 through 13, mentioned above. In addition, some preliminary attempts to analyze the significance of various factors in affecting compliance rates have been made using statistical techniques such as linear regressions. Further analyses along these lines will be made in the near future.

Wherever possible, the data have been tabulated and presented to give conservative measures of noncompliance. For example, omitting the 21 percent of sampled workers with about 8 percent of the income who could not be located can be expected to raise the reported rate of compliance. Common sense and experience would suggest that the types of people who cannot be located despite dilegent searches by the Internal Revenue Service have lower than average tax compliance rates. In addition, the workers who could not be located generally received small payments, and small payments are associated with higher than average noncompliance rates.

Drawing the sample from a selection of payor returns actually subject to employment tax audits does produce a representative sample for the purposes of this Study. The initial employer audits were random and were only to determine if the employers had properly paid their employment taxes and if payments made to independent contractors actually should have been treated as payments to employees subject to FICA taxes and income tax withholding. In selecting the employers for audit, no determination was made about the recipients of these payments.

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Table 1

Employee/Independent Contractor Compliance Study

Compliance Rates -- By Amount of Compensation Received 1/

Amount of Compensation (as corrected)	Income Tax Compliance Rate: Percentage of Compensation Reported	Income Tax Compliance Rate: Percentage of Payees with .... Full Compliance	Partial Compliance	Zero Compliance	Social Security Tax Compliance Rate: Percentage of SECA Tax Paid	Social Security Tax Compliance Rate: Percentage of Payees Having Paid.... All or Some of SECA Tax	None of SECA Tax
Less than $100	25.0%	23.5%	0 %	76.5%	2/	2/	2/
$ 100 to $ 200	24.6	25.1	0	74.9	2/	2/	2/
$ 200 to $ 500	33.6	31.4	1.9	66.6	2/	2/	2/
$ 500 to $ 1,000	42.0	38.1	3.8	58.1	22.9%	22.6%	77.4%
$ 1,000 to $ 2,000	48.4	45.5	3.0	51.5	30.7	30.7	69.3
$ 2,000 to $ 5,000	60.8	54.3	6.9	38.9	44.7	44.7	55.3
$ 5,000 to $10,000	70.8	63.0	8.8	28.2	58.8	59.5	40.5
$10,000 to $15,000	80.5	74.1	7.2	18.6	71.6	73.3	26.7
$15,000 to $20,000	92.0	86.3	6.9	6.9	88.0	86.2	13.8
$20,000 to $50,000	86.6	75.0	13.6	11.4	88.3	85.3	14.7
$50,000 and over	98.4	92.0	8.0	0	66.7	66.7	33.3
All 3/	76.2%	48.2%	4.9%	46.9%	66.0%	38.1%	61.9%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 19, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.
2/ Not meaningful because self-employment income of less than $400 is not subject to self-employment (SECA) tax.
3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 2

Employee/Independent Contractor Compliance Study

Compliance Rates -- By Adjusted Gross Income 1/

Adjusted Gross Income	Income Tax Compliance Rate				Social Security Tax Compliance Rate		
	Percentage of Compensation Reported	Percentage of Payees with			Percentage of SECA Tax Paid	Percentage of Payees Having Paid....	
		Full Compliance	Partial Compliance	Zero Compliance		All or Some of SECA Tax	None of SECA Tax
Less than $ 5,000	51.0%	30.6%	2.2%	67.2%	42.6%	22.1%	77.9%
$ 5,000 to $ 10,000	62.8	42.2	6.4	51.4	52.1	35.4	64.6
$ 10,000 to $ 15,000	72.8	50.0	5.0	45.0	64.2	41.2	58.8
$ 15,000 to $ 20,000	83.2	60.5	5.1	34.4	77.0	49.6	50.4
$ 20,000 to $ 30,000	86.0	64.1	7.1	28.8	83.7	56.6	43.4
$ 30,000 to $ 50,000	89.0	78.1	4.7	17.2	87.8	70.4	29.6
$ 50,000 to $100,000	94.6	77.9	7.8	14.3	91.0	81.5	18.5
$100,000 and over	99.9	88.9	0	11.1	66.7	66.7	33.3
All 2/	76.2%	48.2%	4.9%	46.9%	66.0%	38.1%	61.9%

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June 19, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 3

Employee/Independent Contractor Compliance Study

Compliance Rates -- By Industry 1/

Industry	Income Tax Compliance Rate				Social Security Tax Compliance Rate		
	Percentage of Compensation Reported	Percentage of Payees with			Percentage of SECA Tax Paid	Percentage of Payees Having Paid....	
		Full Compliance	Partial Compliance	Zero Compliance		All or Some of SECA Tax	None of SECA Tax
Real Estate	89.5%	75.1%	4.7%	20.2%	84.3%	69.7%	30.3%
Insurance	98.3	89.8	4.0	6.2	95.5	87.9	12.1
Direct Sales	68.8	51.0	5.7	43.3	53.3	33.3	66.7
Other Sales	74.1	48.2	4.7	47.1	66.6	36.9	63.1
Logging and Timber	52.1	22.9	7.6	69.5	49.2	26.9	73.1
Franchise Operations	73.0	38.3	10.0	51.7	67.1	35.1	64.9
Barber and Beauty Shops	90.0	73.3	6.7	20.0	77.2	66.7	33.3
Trucking	66.7	40.9	4.9	54.2	61.4	35.1	64.9
Taxicabs	43.5	32.4	2.9	64.7	41.1	29.4	70.6
Home Improvement	70.2	39.8	4.6	55.5	58.0	32.8	67.2
Real Estate Construction	63.7	31.3	6.0	62.7	58.1	29.6	70.4
Warehousing	54.0	16.0	4.0	80.0	54.7	19.0	81.0
Eating and/or Drinking Places	58.5	33.1	8.0	58.9	46.2	25.4	74.6
Entertainment	77.9	54.0	4.0	41.9	70.7	46.4	53.6
Exempt Organizations	97.8	76.1	2.2	21.7	79.1	31.4	68.6
Medical and Health Services	90.1	67.4	4.6	28.0	73.0	49.1	50.9
Consulting	76.3	55.6	3.2	41.3	60.7	36.0	64.0
Other 2/	72.5	45.0	4.1	50.7	61.1	33.5	66.5
All 3/	76.2%	48.2%	4.9%	46.9%	66.0%	38.1%	61.9%

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1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Includes all other industries not separately tabulated. Examples of industries reported include farming, manufacturing, janitorial service, messenger service, security service, oil exploration, legal services, nursery, market research, modeling agency, CPA review, opinion survey, snow removal, data processing, funeral home, and landscaping.

3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 4

Employee/Independent Contractor Compliance Study

Compliance Rates -- By Occupation 1/

Occupation	Income Tax Compliance Rate				Social Security Tax Compliance Rate		
	Percentage of Compensation Reported	Percentage of Payees with			Percentage of SECA Tax Paid	Percentage of Payees Having Paid....	
		Full Compliance	Partial Compliance	Zero Compliance		All or Some of SECA Tax	None of SECA Tax
Manager, Distributor	95.7%	78.3%	6.4%	15.3%	91.5%	75.5%	24.5%
Skilled Labor	69.6	42.6	5.4	51.9	60.1	35.4	64.6
Unskilled Labor -- Casual	43.0	25.3	5.5	69.2	27.5	18.0	82.0
Unskilled Labor -- Noncasual	48.5	27.1	3.6	69.3	39.0	21.0	79.0
Driver	66.5	45.3	4.5	50.2	60.7	37.5	62.5
Sales	86.1	71.2	5.0	23.8	80.0	58.5	41.5
Professional	94.4	72.1	5.7	22.2	83.3	54.9	45.1
Clerical	75.2	47.8	6.2	45.9	64.3	37.3	62.7
Entertainer	75.8	52.4	4.0	43.7	62.3	37.9	62.1
Other	77.8	51.1	2.1	46.8	73.8	37.6	62.4
All 2/	76.2%	48.2%	4.9%	46.9%	66.0%	38.1%	61.9%

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1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising the compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Chart 1

PERCENTAGE OF WORKERS WITH ZERO COMPLIANCE

by Size of Compensation

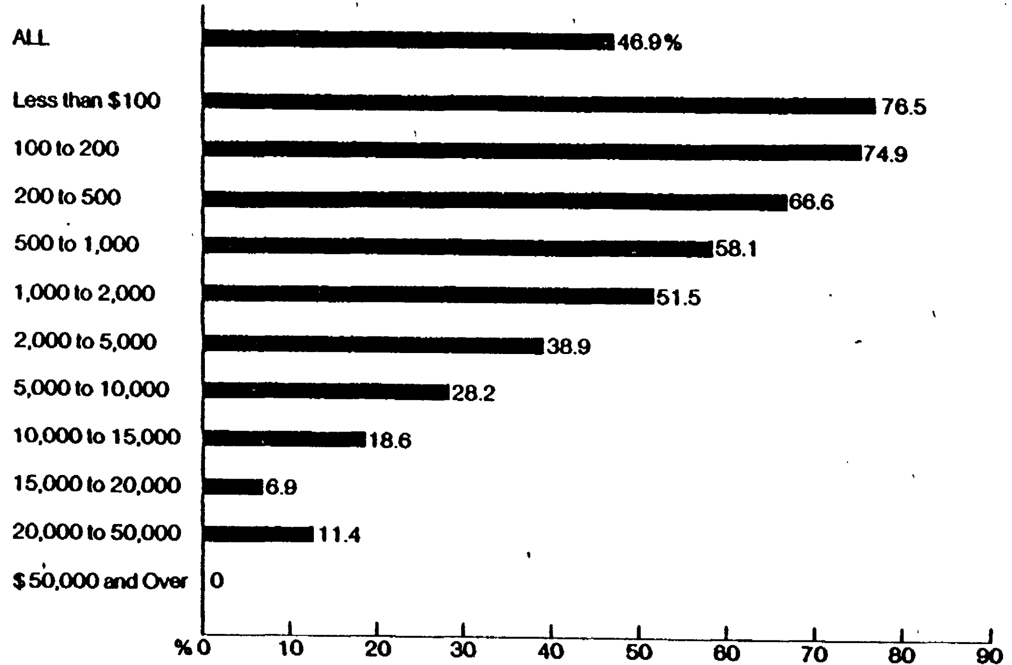

Chart 2

PERCENTAGE OF WORKERS WITH ZERO COMPLIANCE

by Adjusted Gross Income

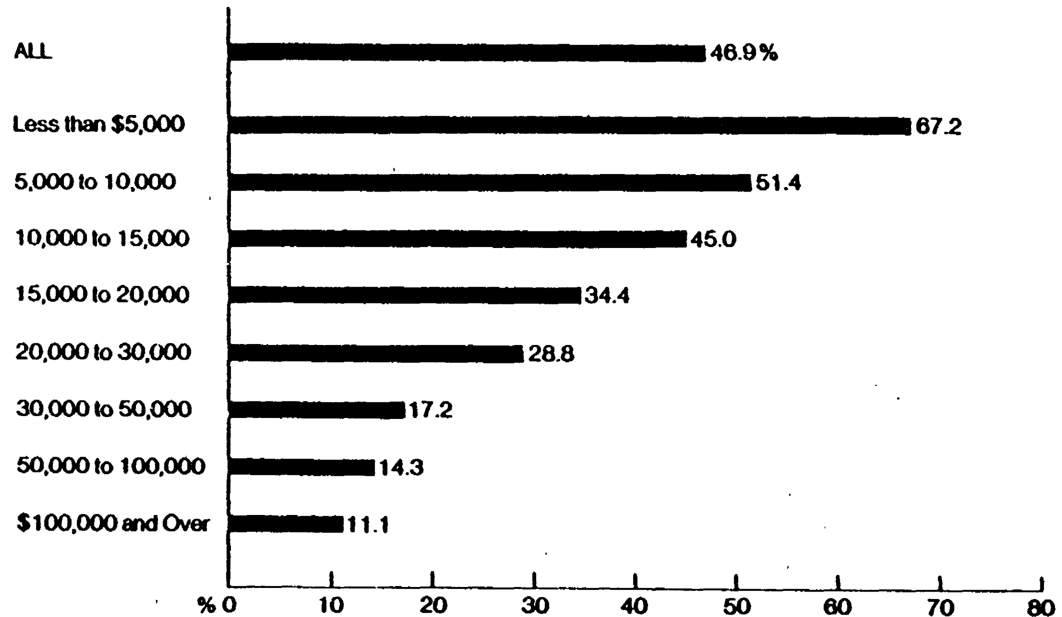

Chart 3

PERCENTAGE OF WORKERS WITH ZERO COMPLIANCE

by Industry

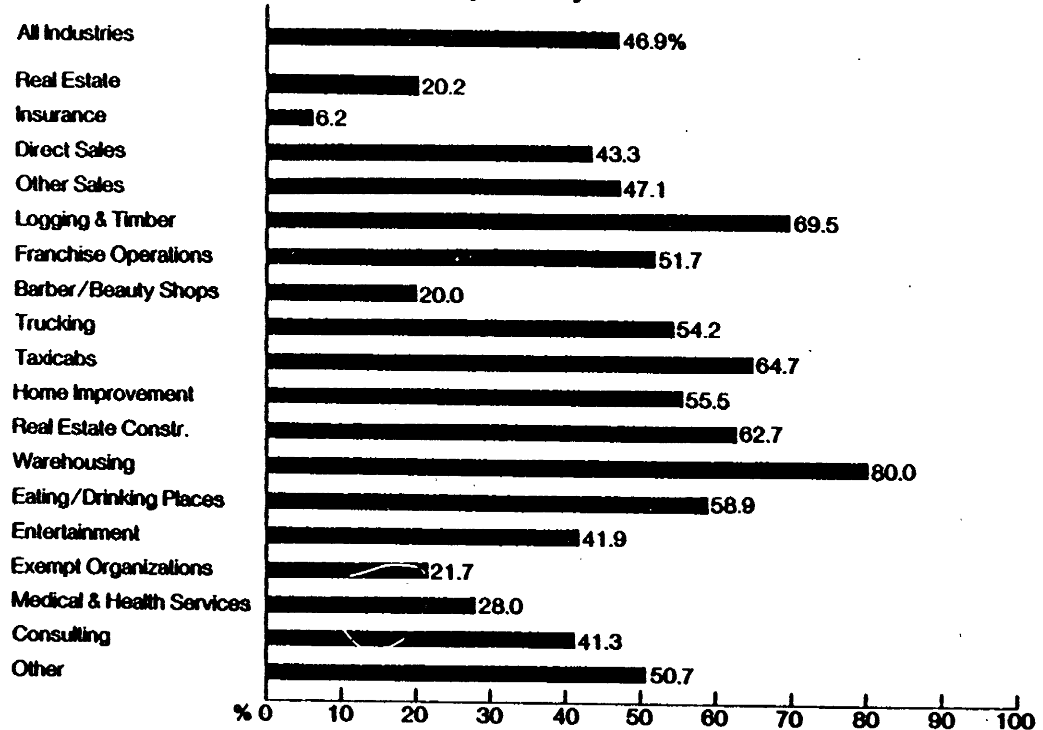

Table 5

Employee/Independent Contractor Compliance Study

Percentage of Compensation Reported and Percentage of Workers Reporting Their Compensation for Income Tax Purposes -- By Amount of Compensation Received 1/

Amount of Compensation (as corrected)	Compliance Rate	Percentage of Compensation on Tax Returns with...					Percentage of Payees with ...				
		Full Compliance	Partial Compliance			Zero Compliance	Full Compliance	Partial Compliance			Zero Compliance
			All	80% - 100% Compliance	0% - 80% Compliance			All	80% - 100% Compliance	0% - 80% Compliance	
Less than $100	25.0%	25.0%	0 %	0 %	0 %	75.0%	23.5%	0 %	0 %	0 %	76.5%
$ 100 to $ 200	24.6	24.6	0	0	0	75.4	25.1	0	0	0	74.9
$ 200 to $ 500	33.6	32.1	2.0	0.6	1.4	65.9	31.4	1.9	0.6	1.4	66.6
$ 500 to $ 1,000	42.0	39.0	4.1	1.3	2.8	56.9	38.1	3.8	1.3	2.5	58.1
$ 1,000 to $ 2,000	48.4	45.8	3.1	2.0	1.1	51.1	45.5	3.0	1.9	1.1	51.5
$ 2,000 to $ 5,000	60.8	55.2	6.9	4.8	2.1	37.9	54.3	6.9	4.7	2.1	38.9
$ 5,000 to $10,000	70.8	63.6	9.0	5.8	3.2	27.5	63.0	8.8	5.7	3.1	28.2
$10,000 to $15,000	80.5	74.8	6.8	4.7	2.1	18.4	74.1	7.2	4.9	2.3	18.6
$15,000 to $20,000	92.0	85.8	7.3	5.7	1.6	6.8	86.3	6.9	5.3	1.5	6.9
$20,000 to $50,000	86.6	75.8	13.3	8.7	4.5	10.9	75.0	13.6	9.8	3.8	11.4
$50,000 and over	98.4	91.9	8.1	4.9	3.3	0	92.0	8.0	4.0	4.0	0
ALL 2/	76.2%	69.2%	8.6%	5.7%	2.9%	22.2%	48.2%	4.9%	3.0%	1.9%	46.9%

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1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded . This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 6

Employee/Independent Contractor Compliance Study

Percentage of Compensation Reported and Percentage of Workers Reporting Their Compensation for Income Tax Purposes -- By Adjusted Gross Income 1/

Adjusted Gross Income	Compliance Ratio	Percentage of Compensation on Tax Returns with...					Percentage of Payees with ...				
		Full Compliance	Partial Compliance			Zero Compliance	Full Compliance	Partial Compliance			Zero Compliance
			All	80% - 100% Compliance	0% - 80% Compliance			All	80% - 100% Compliance	0% - 80% Compliance	
Less than $ 5,000	51.0%	47.0%	4.4%	3.7%	0.8%	48.5%	30.6%	2.2%	1.3%	0.9%	67.2%
$ 5,000 to $ 10,000	62.8	55.0	9.2	6.7	2.5	35.7	42.2	6.4	4.1	2.3	51.4
$ 10,000 to $ 15,000	72.8	64.9	9.3	7.0	2.3	25.9	50.0	5.0	3.1	1.9	45.0
$ 15,000 to $ 20,000	83.2	76.3	8.1	5.7	2.3	15.6	60.5	5.1	3.7	1.4	34.4
$ 20,000 to $ 30,000	86.0	74.9	14.0	8.8	5.2	11.0	64.1	7.1	4.0	3.1	28.8
$ 30,000 to $ 50,000	89.0	84.0	7.0	2.3	4.8	8.9	78.1	4.7	1.7	3.0	17.2
$ 50,000 to $100,000	94.6	92.8	2.3	1.8	0.5	4.9	77.9	7.8	3.9	3.9	14.3
$100,000 and over	99.9	99.9	0	0	0	0.1	88.9	0	0	0	11.1
ALL 2/	76.2%	69.2%	8.6%	5.7%	2.9%	22.2%	48.2%	4.9%	3.0%	1.9%	46.9%

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Office of Tax Analysis

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1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 7

Employee/Independent Contractor Compliance Study

Percentage of Compensation Reported and Percentage of Workers Reporting Their Compensation for Income Tax Purposes -- By Industry 1/

Industry	Compliance Rate	Percentage of Compensation on Tax Returns with...					Percentage of Payees with ...				
		Full Compliance	Partial Compliance			Zero Compliance	Full Compliance	Partial Compliance			Zero Compliance
			All	80% - 100% Compliance	0% - 80% Compliance			All	80% - 100% Compliance	0% - 80% Compliance	
Real Estate	89.5%	83.8%	7.2%	2.7%	4.5%	9.0%	75.1%	4.7%	1.9%	2.8%	20.2%
Insurance	98.3	95.6	2.9	2.4	0.5	1.5	89.8	4.0	2.7	1.3	6.2
Direct Sales	68.8	62.5	8.5	3.9	4.6	29.0	51.0	5.7	3.0	2.8	43.3
Other Sales	74.1	70.4	4.7	2.6	2.0	24.9	48.2	4.7	2.2	2.4	47.1
Logging & Timber	52.1	37.1	17.4	15.7	1.7	45.6	22.9	7.6	6.7	1.0	69.5
Franchise Operations	73.0	47.7	29.9	25.5	4.4	22.4	38.3	10.0	8.3	1.7	51.7
Barber & Beauty Shops	90.0	82.3	8.1	8.1	0	9.6	73.3	6.7	6.7	0	20.0
Trucking	66.7	54.9	13.0	10.9	2.1	32.1	40.9	4.9	4.3	0.7	54.2
Taxicabs	43.5	39.5	6.7	0	6.7	53.8	32.4	2.9	0	2.9	64.7
Home Improvement	70.2	60.6	10.6	10.0	0.6	28.9	39.8	4.6	3.9	0.8	55.5
Real Estate Construction	63.7	52.6	13.7	9.3	4.4	33.7	31.3	6.0	3.1	2.9	62.7
Warehousing	54.0	29.2	42.1	0	42.1	28.6	16.0	4.0	0	4.0	80.0
Eating and/or Drinking Places	58.5	50.5	11.9	4.6	7.2	37.7	33.1	8.0	3.4	4.6	58.9
Entertainment	77.9	75.5	3.3	0.4	2.9	21.2	54.0	4.0	0.8	3.2	41.9
Exempt Organizations	97.8	97.6	0.2	0.2	0	2.2	76.1	2.2	2.2	0	21.7
Medical & Health Services	90.1	85.3	5.7	2.9	2.8	9.0	67.4	4.6	2.3	2.3	28.0
Consulting	76.3	67.4	9.8	9.8	0	22.9	55.6	3.2	3.2	0	41.3
Other 2/	72.5	66.2	8.3	5.0	3.2	25.5	45.0	4.1	2.6	1.5	50.7
All 3/	76.2%	69.2%	8.6%	5.7%	2.9%	22.2%	48.2%	4.9%	3.0	1.9%	46.9

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Includes all other industries not separately tabulated. Examples of industries reported include farming, manufacturing, janitorial service, messenger service, security service, oil exploration, legal services, nursery, market research, modeling agency, CPA review, opinion survey, snow removal, data processing, funeral home, and landscaping.

3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 8

Employee/Independent Contractor Compliance Study

Percentage of Compensation Reported and Percentage of Workers Reporting Their Compensation for Income Tax Purposes -- By Occupation 1/

Occupation	Compliance Rate	Percentage of Compensation on Tax Returns with...: Full Compliance	Partial Compliance: All	Partial Compliance: 80% - 100% Compliance	Partial Compliance: 0% - 80% Compliance	Zero Compliance	Percentage of Payees with....: Full Compliance	Partial Compliance: All	Partial Compliance: 80% - 100% Compliance	Partial Compliance: 0% - 80% Compliance	Zero Compliance
Manager, Distributor	95.7%	90.6%	6.8%	3.2%	3.6%	2.6%	78.3%	6.4%	3.8%	2.5%	15.3%
Skilled Labor	69.6	59.1	12.5	9.6	2.9	28.4	42.6	5.4	3.7	1.7	51.9
Unskilled Labor -- Casual	43.0	35.7	9.0	6.2	2.7	55.4	25.3	5.5	3.5	1.9	69.2
Unskilled Labor -- Noncasual	48.5	42.7	6.9	5.5	1.5	50.4	27.1	3.6	2.4	1.2	69.3
Driver	66.5	56.9	10.8	8.8	1.9	32.3	45.3	4.5	3.6	0.9	50.2
Sales	86.1	81.0	6.3	2.9	3.5	12.6	71.2	5.0	2.5	2.6	23.8
Professional	94.4	86.8	8.9	6.6	2.4	4.3	72.1	5.7	3.3	2.[illegible]	22.2
Clerical	75.2	68.7	11.0	5.0	6.1	20.3	47.8	6.2	3.8	2.4	45.9
Entertainer	75.8	74.0	3.4	0.3	3.1	22.6	52.4	4.0	0.8	3.2	43.7
Other	77.8	75.7	2.7	1.4	1.2	21.6	51.1	2.1	1.1	1.1	46.8
All 2/	76.2%	69.2%	8.6%	5.7%	2.9%	22.2%	48.2%	4.9%	3.0%	1.9%	46.9%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 9

Employee/Independent Contractor Compliance Study

Income Tax Compliance Rates by Industry and Occupation
(Percentage of Compensation Received Which Was Reported On Tax Returns) 1/

	Manager, Distributor	Skilled Labor	Unskilled Labor-- Casual	Unskilled Labor-- Noncasual	Driver	Sales	Professional	Clerical	Entertainer	Other	All
Real Estate	91.5%	81.9%	42.5%	4.5%		94.2%	76.4%	7.6%		76.4%	89.5%
Insurance	99.9					90.0	81.4	82.0			90.3
Direct Sales	75.4	33.4	48.2	53.2	63.5%	76.3	85.3	20.0		53.0	60.0
Other Sales	77.7	59.6	46.0	43.5	63.3	83.9	65.1	65.3	47.7%	40.4	74.06
Logging and Timber		60.1	21.8	44.0	73.0						52.1
Franchise Operations	92.9	27.2	*			71.0				*	73.0
Barber and Beauty Shops		90.0					100.0				90.0
Trucking		87.9	20.0	46.7	67.2	90.4				21.53	66.7
Taxicabs					43.9						43.5
Home Improvement	56.2	69.4	47.9	62.3	27.2	85.5		72.6		60.6	70.2
Real Estate Construction	75.6	66.3	21.0	51.3	81.0	88.5	85.4			81.9	63.0
Warehousing			22.0	*							54.0
Eating and/or Drinking Places	52.8	54.2	22.9	44.0			29.4	45.1	65.1	20.4	50.5
Entertainment	100.0	86.0	59.6	97.0	100.0	60.1	77.0		74.6	85.0	77.9
Exempt Organizations			93.4	82.0			99.9	64.7		73.3	97.0
Medical and Health Services	100.0	93.05	54.2	23.0	60.6	42.0	95.8	51.1		50.5	90.1
Consulting		91.4	26.1	100.0			77.3	40.2		92.0	76.3
Other 2/	65.2	60.5	32.6	50.3	54.0	85.6	92.7	82.7	83.2	81.0	72.4
All 3/	88.7%	67.7%	36.1%	50.6%	65.0%	89.0%	92.5%	69.0%	70.5%	73.1%	76.2%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Includes all other industries not separately tabulated. Examples of industries reported include farming, manufacturing, janitorial service, messenger service, security service, oil exploration, legal services, nursery, market research, modeling agency, CPA review, opinion survey, snow removal, data processing, funeral home, and landscaping.

3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 10

Employee/Independent Contractor Compliance Study

Worker Social Security Tax Compliance Rates -- by Amount of Compensation Received 1/

Amount of Compensation	Workers' Social Security Tax Compliance Rate Assuming:		Percentage of Workers Having Paid:	
	Subject to FICA or SECA, as on Audit	Subject to SECA	All or Some of the Social Security Tax	None of the Social Security Tax
Less than $ 100	2/	2/	2/	2/
$ 100 - $ 200	2/	2/	2/	2/
$ 200 - $ 500	2/	2/	2/	2/
$ 500 - $ 1,000	26.6 %	22.9 %	22.6 %	77.4 %
$ 1,000 - $ 2,000	34.7	30.7	30.7	69.3
$ 2,000 - $ 5,000	49.2	44.7	44.7	55.3
$ 5,000 - $10,000	63.4	58.8	59.5	40.5
$10,000 - $15,000	74.7	71.6	73.3	26.7
$15,000 - $20,000	90.7	88.0	86.2	13.8
$20,000 - $50,000	89.5	88.3	85.3	14.7
$50,000 and over	66.7	66.7	66.7	33.3
All 3/	70.0 %	66.0 %	38.1 %	61.9 %

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.
2/ Not meaningful because self-employment income of less than $400 is not subject to self-employment (SECA) tax.
3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 11

Employee/Independent Contractor Compliance Study

Worker Social Security Tax Compliance Rates -- by Adjusted Gross Income 1/

Adjusted Gross Income	Workers' Social Security Tax Compliance Rate Assuming:		Percentage of Workers Having Paid:	
	Subject to FICA or SECA, as on Audit	Subject to SECA	All or Some of the Social Security Tax	None of the Social Security Tax
Less than $ 5,000	46.7 %	42.6 %	22.1 %	77.9 %
$ 5,000 - $ 10,000	56.4	52.1	35.4	64.6
$ 10,000 - $ 15,000	68.2	64.2	41.2	58.8
$ 15,000 - $ 20,000	80.3	77.0	49.6	50.4
$ 20,000 - $ 30,000	86.8	83.7	56.6	43.4
$ 30,000 - $ 50,000	90.2	87.8	70.4	29.6
$ 50,000 - $100,000	92.1	91.0	81.5	18.5
$100,000 and over	66.7	66.7	66.7	33.3
All 2/	70.0 %	66.0 %	38.1 %	61.9 %

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

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Table 12

Employee/Independent Contractor Compliance Study

Worker Social Security Tax Compliance Rates - by Industry 1/

Industry	Workers' Social Security Tax Compliance Rate Assuming:		Percentage of Workers Having Paid:	
	Subject to FICA or SECA, as on Audit	Subject to SECA	All or Some of the Social Security Tax	None of the Social Security Tax
Real Estate	85.6%	84.3%	69.7%	30.3%
Insurance	96.2	95.5	87.9	12.1
Direct Sales	57.4	53.3	33.3	66.7
Other Sales	70.2	66.6	36.9	63.1
Logging and Timber	53.6	49.2	26.9	73.1
Franchise Operations	70.6	67.1	35.1	64.9
Barber and Beauty Shops	87.2	77.2	66.7	33.3
Trucking	65.2	61.4	35.1	64.9
Taxicabs	46.7	41.1	29.4	70.6
Home Improvement	62.7	58.0	32.8	67.2
Real Estate Construction	62.1	58.1	29.6	70.4
Warehousing	57.1	54.7	19.0	81.0
Eating and/or Drinking Places	50.8	46.2	25.4	74.6
Entertainment	74.6	70.7	46.4	53.6
Exempt Organizations	89.0	79.1	31.4	68.6
Medical and Health Services	76.4	73.0	49.1	50.9
Consulting	68.2	60.7	36.0	64.0
Other 2/	64.7	61.1	33.5	66.5
All 3/	70.0%	66.0%	38.1%	61.9%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.
2/ Includes all other industries not separately tabulated. Examples of industries reported include farming, manufacturing, janitorial service, messenger service, security service, oil exploration, legal services, nursery, market research, modeling agency, CPA review, opinion survey, snow removal, data processing, funeral home, and landscaping.
3/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 13

Employee/Independent Contractor Compliance Study

Worker Social Security Tax Compliance Rates -- By Occupation 1/

Occupation	Workers' Social Security Tax Compliance Rate Assuming:		Percentage of Workers Having Paid:	
	Subject to FICA or SECA, as on Audit	Subject to SECA	All or Some of the Social Security Tax	None of the Social Security Tax
Manager, Distributor	92.6 %	91.5 %	75.5 %	24.5 %
Skilled Labor	64.7	60.1	35.4	64.6
Unskilled Labor -- Casual	30.8	27.5	18.0	82.0
Unskilled Labor -- Noncasual	43.5	39.0	21.0	79.0
Driver	64.5	60.7	37.5	62.5
Sales	82.7	80.0	58.5	41.5
Professional	86.7	83.3	54.9	45.1
Clerical	67.9	64.3	37.3	62.7
Entertainer	67.5	62.3	37.9	62.1
Other	79.8	73.8	37.6	62.4
All 2/	70.0 %	66.0 %	38.1 %	61.9 %

Office of the Secretary of the Treasury
Office of Tax Analysis

June 15, 1979

1/ All percentages are based on returns actually audited. Data for payees who could not be identified, located, or contacted are excluded. This omission has the effect of raising compliance rates.

2/ Based on simple tabulation of raw data. Weighting does not affect results substantially.

Table 14

Employee/Independent Contractor Compliance Study

Explanation of Differences Between Sample Selected and Sample Audited and Tabulated

	Number of Returns	Percentage of Returns	Amount of Compensation	Percentage of Compensation
Total Sample Selected	7,109	100 %	$24,840,019	100 %
Less:				
Unable to Locate	1,522	21.4	2,094,152	8.4
Unable to Contact	90	1.3	202,281	0.8
Not Liable for Taxes	333	4.7	204,783	0.8
Other	12	0.1	16,845	0.1
Audited and Tabulated	5,152	72.5%	$22,322,318	89.9 %

Office of the Secretary of the Treasury
Office of Tax Analysis

June 13, 1979

Attachment I

Employee Examination Checksheet
Employee/Independent Contractor Compliance Study

Employee Sample Control Number

1. Employee's Name and Address:

5. Employer's Name and Address:

2. SSN: ____ - ____ - ____

3. Amount of Reclassified Wages .... $ ________

4. Years: ☐ 1976 ☐ 1977

6. EIN: ____ - ________

7. Industry/Occupation Codes .... ☐☐☐

RETURN IDENTIFICATION

8. Return Filing Record (to be completed by RPM)
   - (a) ☐ Return Secured and Attached
   - (b) ☐ Return Not Secured
   - (c) ☐ Return Assigned to: (Please Associate)

9. Source of Returns:
   - (a) ☐ Initial Selection
   - (b) ☐ Delinquent Return Secured (Collection Referral)
   - (c) ☐ Previously Filed (Collection Referral)
   - (d) ☐ Refusal to File (Collection Referral)

10. If Taxpayer Not Liable to File Return [S/E Income less than $400 and Total Income less than return filing requirement] Check here ☐ and Complete Items 30 thru 34 ONLY.

11a. Was Return Previously Examined? ☐ Yes ☐ No
   - b. If Yes, was it Reopened? ☐ Yes ☐ No
   - c. If not Reopened, can edit sheet be completed from closed case file? ☐ Yes, do so ☐ No, see instructions

12. Enter HCR CODE:

13. Enter DIF SCORE:

RECLASSIFIED WAGES

14a. Enter Employer's Business: ________ CODE: ________
   - b. Enter Services Associated with Reclassified Wages: CODE:

15. Where and what amount of the "Reclassified Wages" (Item #3) were reported on return for Income Tax purposes? (Dollars only)

	Per Return	As Corrected
(a) Wages and Salaries	$ ________	$ ________
(b) Schedule C Gross Receipts	$ ________	$ ________
(c) Schedule F Gross Receipts	$ ________	$ ________
(d) Other Income	$ ________	$ ________
☐ None Reported		

16. Amount of Reclassified Wages (Item #3) reported for SECA/FICA purposes. (Dollars only)

	Per Return	As Corrected
(a) For FICA purposes	$ X X X X X X X	$ ________
(b) For SECA purposes	$ ________	$ ________
☐ None Reported		

17. The basis for the determinations in questions 15 and 16 was:
   - (a) ☐ Specific identification of the item
   - (b) ☐ Customary indirect methods of determining income
   - (c) ☐ Other (explain in remarks)

RECLASSIFIED WORKER (Questions 18 and 19 refer to the income of the reclassified worker only. Do not include income of spouse if this is a joint return.)

18. Total of all Schedules C and Schedules F for Reclassified Worker (Dollars only)

	Per Return	As Corrected
(a) Gross Receipts	$ ________	$ ________
(b) Gross Profit (or Loss)	$ ________	$ ________
(c) Net Profit (or Loss)	$ ________	$ ________

19. FICA and SECA for Reclassified Worker (Dollars only)

	Per Return	As Corrected
(a) Total wages from FICA covered sources (disregard FICA limitation)	$ ________	$ ________
(b) Total net earnings from self-employment (line 13, Form S/E)	$ ________	$ ________
(c) Self-employment income (line 17, Form S/E)	$ ________	$ ________
(d) Self-employment tax (line 18, Form S/E)	$ ________	$ ________

TAX RETURN SUMMARY (Questions 20 thru 27 call for data from return, including spouse if return is joint. Enter all data which is appropriate.)

20. Years: ☐ 1976 ☐ 1977

21. Filing Status:

	Per Return (check one)	As Corrected (check one)
(a) Single	☐	☐
(b) Joint	☐	☐
(c) Head of Household	☐	☐
(d) Married Filing Separately ...	☐	☐
(e) Surviving Spouse	☐	☐

(Dollars only)

	Per Return	As Corrected
22. Adjusted Gross Income	$ ________	$ ________
23. Taxable Income	$ ________	$ ________
24. Tax Table Income (1977 only)	$ ________	$ ________
25. Number of Exemptions	________	________
26. Income tax after credits but excluding minimum tax	$ ________	$ ________
27. Minimum Tax	$ ________	$ ________

AUDIT STATUS

28. Status:
   - (a) ☐ Final – Audit Completed.
   - (b) ☐ Final as to reclassified wages. Still open on other issues. ▶
   - (c) ☐ Incomplete. ▶

Estimated completion Date: ________ (Fill in if (b) or (c) is checked)

29. REMARKS: (Index each item by its corresponding number and letter)

Approved:

30. Preparer's Name	31. District or Service Center Code	32. Organization Code	33. Telephone (FTS)	34. Date Prepared

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Attachment II

Employer Size Indicator
Employee/Independent Contractor Compliance Study

Reserved

(1) Employer's Name and Address:

(2) Taxpayer Identifying Numbers

(3) Tax Years
☐ 1976
☐ 1977

EMPLOYER SIZE INDICATOR

(4) For tax year YY MM return.

(5) Tax return of employer
1 ☐ 1040
2 ☐ 1065
3 ☐ 1120, 1120-S, 1120 L, etc.
4 ☐ Exempt Organization
5 ☐ Other (explain)

BUSINESS INCOME:

(6) 1 ☐ Actual
2 ☐ Estimate
3 ☐ Not available/no basis for estimate

(7) 1 ☐ Under $50,000
2 ☐ $50,000 under $100,000
3 ☐ $100,000 under $1,000,000
4 ☐ $1,000,000 under $10,000,000
5 ☐ $10,000,000 under $100,000,000
6 ☐ $100,000,000 and over

BUSINESS ASSETS:

(8) 1 ☐ Actual
2 ☐ Estimate
3 ☐ Not available/no basis for estimate

(9) 1 ☐ Under $100,000
2 ☐ $100,000 under $500,000
3 ☐ $500,000 under $5,000,000
4 ☐ $5,000,000 under $50,000,000
5 ☐ $50,000,000 under $250,000,000
6 ☐ $250,000,000 and over

REMARKS:

RESERVED:

(10) Preparer's Name	(11) District or S.C. Code	(12) Organization Code	(13) Telephone Number (FTS)	(14) Date

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Senator BYRD. Next, there will be a panel of witnesses dealing with S. 736, which is Senator Dole's proposal.

The panel will be Dr. Jack W. Carlson, executive vice president, National Association of Realtors, accompanied by Mr. Gil Thurm, legislative counsel, National Association of Realtors; Mr. Neil H. Offen, president, Direct Selling Association, accompanied by Mr. Arthur Rothkopf and Mr. John Beyer; Mr. Gustav J. Lehr, executive vice president, MFA Insurance Cos., Columbia, Mo.; Mr. Robert M. Dunville, Sr., president, Robert M. Dunville Bros., Inc., Richmond, Va., representing the Associated General Contractors of America.

If there are others, I would be glad for you to identify yourselves.

Senator DOLE. Mr. Chairman, I would like to submit a statement for the record in support of S. 736. My statement points out some of the areas that I consider to be important.

Senator BYRD. Yes, Senator Dole. That will be incorporated in the record.

[The statement of Senator Dole follows:]

STATEMENT OF SENATOR BOB DOLE

Mr. Chairman, one of the bills before the subcommittee today is S. 736, the Employment Tax Act of 1979. The legislation addresses a very important issue. If enacted it will bring some certainty into a very controversial area of the tax law.

Independent contractors are distinguished from employers for tax purposes by the common law. The common law rules and the application of these rules by the courts have produced decisions and guidelines that until a few years ago were widely understood and accepted. However, in the early 1970's, the Internal Revenue Service launched an aggressive audit campaign of employment taxes. The problem of increased audits and the retroactive tax assessments which were issued by the IRS, brought a number of complaints from many taxpayers, including direct sellers, insurance salespersons, realtors, loggers, truckers, and many more.

Mr. Chairman, I need not remind members of the Finance Committee that the distinction between the independent contractors and an employee is important because employers do not have to withhold on wages of independent contractors, nor pay social security or employment taxes. If the Internal Revenue service decides to challenge the employment status and prevails, the employer becomes liable for employment taxes which have not been withheld or paid to the Treasury. It is a very serious problem.

Because the Internal Revenue Service had changed the rules of the game, in its opinion of tax treatment of independent contractors, the 1978 Revenue Act contained a provision which I sponsored to allow employers to continue to treat individuals as independent contractors as long as there was a reasonable basis for treating them as independent contractors in the past. Section 530 of the Revenue Act has temporarily solved the problem. To demonstrate my commitment to find the right solution, I have introduced S. 736.

The bill sets forth five requirements that, if satisfied, would result in a worker being treated as an independent contractor. I believe it is a sound proposal. It means legitimate businessmen and workers will be able to conduct their affairs without undue restrictions or without harassment. I am concerned, as any Senator who sits on this committee, about tax compliance. However, I do not believe we should enact measures that would eliminate the status of the independent contractors.

The relief provided in the 1978 tax bill expires at the end of this year. If we cannot satisfactorily resolve this issue, I believe that section 530 should be immediately extended so that Congress will have the time to resolve the issue.

Mr. Chairman, I appreciate your scheduling this hearing.

Mr. CARLSON. If I may submit my longer statement for the record, I would appreciate it, and I have a shorter one.

Senator BYRD. Certainly.

STATEMENT OF JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, ACCOMPANIED BY GIL THURM, VICE PRESIDENT AND LEGISLATIVE COUNSEL, GOVERNMENT AFFAIRS, NATIONAL ASSOCIATION OF REALTORS

Mr. CARLSON. My name is Jack Carlson, executive vice president and chief economist, and I am accompanied by Gil Thurm, vice president and legislative counsel, government affairs of the National Association of Realtors.

Senator BYRD. As the witnesses know, the four witnesses will have 5 minutes each.

Mr. CARLSON. This association, with over 726,000 members, is the largest trade association in the United States. We are concerned with all facets of the real estate industry—residential, commercial, industrial, and farm real estate.

We are pleased to testify today in support of the Employment Tax Act of 1979, S. 736, introduced by Senators Dole, DeConcini, and Matsunaga. We urge that the committee favorably report the bill.

Over the last several years, the IRS has misapplied the longstanding common law test to the point that it was attempting to coerce independent contractors in the real estate industry into employee status. That is, the IRS was trying to remove the freedom of choice of business relationships.

We thank the members of the committee and Congress in general for providing the needed interim relief from unjustified IRS harassment activity. This important relief provided by section 530 of the Revenue Act of 1978 will expire at the end of this year. That is why it is important to focus now on reasonable legislative standards for next and future years.

The National Association of Realtors supports S. 736 for providing reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or independent contractor. The bill provides a "safe harbor" by giving certainty as to tax status to independent contractors who are able to meet the five strict requirements contained in the bill. At the same time, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five "safe harbor" provisions.

The five requirements for "safe harbor" treatment in the bill are very strict, and should be strict to prevent workers who should obviously be classified as employees from inadvertently being reclassified as independent contractors. The bill was not designed or intended to allow massive switchovers and any objections on this point can be addressed through an antiswitch amendment if this objection proves to be a legitimate concern.

The Treasury Department proposal concerning the independent contractor issue does not focus on the need to clarify the status of workers as employees or independent entrepreneurs. Rather, the proposal of the Treasury Department concentrated on the initiation of a new 10-percent withholding system for independent contractors.

This is greater than 14 percent of the effective tax as it is imposed on the basis of an individual's gross receipts. Inasmuch as

gross income is much greater than net income, you are going to have people overpaying under that system.

The basis for this proposal is an IRS tax compliance study purportedly showing that a large percentage of independent contractors apparently do not pay their fair share of taxes. That IRS study, however, is of dubious validity for a variety of reasons we will set forth. Even though that study places the real estate industry among the highest category of tax compliance, we will illustrate that our compliance is even better than indicated.

Accordingly, it is unwise, excessively costly, unnecessary, and a restriction of the freedom of choice to consider a new, burdensome and complex withholding scheme on the basis of an invalid study.

A limited amount of the tax return information on which the IRS study was based was made available to the public on July 5 pursuant to the Freedom of Information Act. After a review of even this limited data, we believe the study to be seriously deficient because of problems associated with sample selection, sample size, and other methodology used in the study. I used to be Assistant Director of the Office of Management and Budget in charge of evaluation. It is my professional judgment that I would be ashamed to be associated with the Treasury Department given the kind of sampling that they have in this study.

Nevertheless, even according to the figures presented in the study, real estate salespeople have a compliance rate in excess of 96 percent. This compliance rate is much higher than that of the average taxpayer.

Given this high degree of compliance by the independent contractors in the real estate industry, we do not see how compliance could significantly improve if a withholding system were initiated. Even if some compliance problem were proven to exist, it would be premature to propose a new withholding system when simple and available administrative remedies have not been utilized to address the problem.

Let us make no mistake that a withholding system would be costly and burdensome. Many real estate brokers do not have any employees and therefore do not use any withholding system at present. For these small businesspeople, a withholding system would impose a new, unfamiliar and costly burden.

A conservative estimate of the cost to each broker to implement and maintain such a withholding system is $500 per year. When we take into account the more than 200,000 real estate brokers who use independent contractors, which is 90 percent of all brokers, the total cost of withholding in the real estate industry alone is $100 million per year, $1 billion over a 10-year period.

This is just the cost of taking care of the system; not any additional taxes that might be paid.

Ultimately, this additional cost must be passed onto homeowners and other property owners and translates into an additional cost of $25 for each home purchased and $150 additional for the average household members during their lifetime.

The additional cost of $500 must be compared with the maximum possible increase of taxable income of $187 per real estate company according to the IRS study, which would require 100 percent absolute compliance. So, we have the Federal Government requiring

people to spend $500 so that the IRS under perfect conditions could collect $187.

And, since the $500 is a deductible business expense, and many realtors may be paying a marginal tax rate of 38 percent or higher, the Treasury could realize less net tax revenues from the real estate industry if a withholding system is initiated, even under perfect conditions.

In the most likely case, the IRS must expect less taxes from their proposed withholding system. Realistically, 1 percent or possibly 2 percent higher compliance is the best that can be expected. Even this amount would place compliance of real estate salespeople at 97 percent to 98 percent, above most sectors of the U.S. economy.

At this higher compliance level, an average of $50 more in taxes may be collected but only by imposing a withholding cost and burden of at least $500. Thus, the IRS would require $10 to be spent by every broker for every $1 in additional tax receipts.

In the case of your home State of Virginia, Mr. Chairman, as shown on table 6 in my written statement, the average real estate business would be forced to spend $495 more each year to satisfy IRS's proposed reporting system which would ultimately increase the cost of homes in Virginia by $24.75 each or a total of $2,500,000 higher cost for the homes expected to be purchased during 1980 and each year thereafter in Virginia.

For this huge increase in cost, the IRS may collect $47 from each real estate business or $2.50 per home or $230,000 from the entire State. Thus, realtors and homeowners in Virginia would have to pay $10 for each additional $1 collected by the IRS.

In summary, the IRS compliance study is not an accurate indicator of tax compliance by independent contractors in the real estate industry and, even if one accepts the figures in the study, the compliance rates shown for these independent contractors are already extremely high. As a result, a withholding system is simply not warranted or necessary or desirable.

However, we do need reasonable legislative standards for determining independent contractor status to substitute for arbitrary determinations made by the IRS. Accordingly, we urge the committee to help resolve this problem and favorably report S. 736 to the full Senate.

We appreciate this opportunity to present our views on this matter of urgent concern. We will be happy to try to answer any questions the committee may have.

Thank you.

Senator BYRD. Thank you.

Who is the next witness?

Mr. OFFEN. I am Neil H. Offen, president of the Direct Selling Association. With me is the president of our consulting firm, John Beyer, and our counsel, Arthur Rothkopf.

I would like to submit our full statement, and an economic impact study done by Robert R. Nathan for the record.

Senator BYRD. Your full statement and the impact study will be made a part of the official record.

Mr. OFFEN. Thank you, Mr. Chairman.

I would like to submit a two-page summary of the defects that our economic consultants have found with the IRS study.

Senator BYRD. The summary will also be inserted into the record.
Mr. OFFEN. Thank you, sir.
[The material referred to follows:]

DEFECTS IN THE IRS COMPLIANCE STUDY

The Treasury proposal to extend tax withholding to independent contractors is based on an IRS compliance study of 5,152 individuals which concludes the tax compliance for independent contractors is poor. This study and the conclusions drawn from it are too seriously flawed to serve as the basis for such a fundamental tax change.

THE IRS FAILED TO ESTIMATE COMPLIANCE RATES CORRECTLY

The IRS failed to compare taxes paid on independent contractor income to total taxes owed. Using the IRS's own data for the 5,152 workers in the study, it is estimated that 90 percent of the taxes owed on this income have been paid. Failure to measure this most basic and meaningful compliance rate is a serious flaw in the IRS study.

The IRS failed to utilize net income as the most appropriate measure for calculating compliance rates, resulting in an overstatement of non-compliance.

The IRS failed to include in the compliance estimate individuals whose total income was below the level of that required for filing returns. This resulted in further overstatement of non-compliance.

The IRS failed to measure tax compliance where information returns (Forms 1099) are furnished to independent contractors. Such a correlation would have indicated whether better information reporting would lead to increased compliance.

The IRS included as non-compliers a large number of workers (estimated to be almost 20 percent of the sample) whom the IRS found had no tax liability as independent contractors.

EVEN THE IRS DATA DEMONSTRATE THAT ADDITIONAL REVENUE FROM TAX WITHHOLDING WILL BE SMALL

The Treasury has stated that withholding and strengthened information reporting would raise the tax compliance rate to approximately 90 percent, but the IRS study supports the conclusion that the tax compliance rate for independent contractors is already at that level.

The IRS study shows that additional revenue would come from a very small proportion of independent contractors.

Two-thirds of the audited workers had no unpaid taxes.

Four-fifths had an average unpaid tax of only $8.32.

Fourteen percent of the audited workers account for 87 percent of the unpaid tax.

THE OVERALL DESIGN OF THE STUDY IS HIGHLY DEFICIENT

The sample of individuals audited is not representative of independent contractors.

The universe of independent contractors is not known, which the Treasury explicitly admits.

The sample of workers was drawn only from tax cases where employment status was under dispute.

The sample of audited workers was drawn from a larger sample which the Treasury has stated is not representative of independent contractors.

Over one-third of the workers were drawn from insurance salespersons, which does not reflect the composition of the independent contractor population.

The "Direct Sales" category includes workers with occupations foreign to the industry—entertainers, drivers and a large number of unskilled laborers.

The sample was not random. Over 21 percent of the original sample could not be located and was not replaced, contributing to sample bias.

The large number of skilled and unskilled workers in the sample (almost one-half) is not consistent with the known characteristics of independent contractors.

Acceptable measures of statistical reliability have not been provided, so that the reliability of the compliance rates are not known.

For many industry and occupational groupings in the study, the number of workers audited is too small to estimate compliance with statistical reliability.

STATEMENT OF NEIL H. OFFEN, PRESIDENT, DIRECT SELLING ASSOCIATION, ACCOMPANIED BY ARTHUR ROTHKOPF, ESQ., COUNSEL; AND JOHN BEYER

Mr. OFFEN. Rather than indicate support for the Dole bill, which we do, and outline our reasons for support, I would like to address myself to the IRS withholding study and recommendations.

The Treasury Department has made some very serious proposals. We think they are made in good faith. We understand the problem that the Treasury Department is trying to solve.

In direct selling, there are over 4 million individuals involved, 89 percent work less than 10, hours, 80 percent are women, 15 percent are minorities, and another 10 percent are either senior citizens or have some sort of handicap.

Our industry is open to all. We want to keep it that way.

The Treasury Department has criticized S. 736 as allowing significant numbers of employers to switch the status of their employees to independent contractors. We believe that the Treasury has vastly overstated this possibility.

Qualifying for independent contractor status under the bill would require substantial changes in the traditional employer-employee relationship, changes from a business point of view that would be undesirable and uneconomical.

The accounting firm of Touche, Ross & Co. has analyzed this question and has reached a similar conclusion. We support S. 726 because it provides a "safe-harbor" for those companies desiring certainty against IRS challenge. Our support for the bill is based on the "safe-harbor" approach, in which we see the common law test maintained.

The bill does not abandon that test.

We vigorously oppose the administration's withholding tax proposal for several reasons. We would rather see no "safe-harbor" legislation enacted if the price were withholding.

In the first place, the Treasury proposal is based on an IRS compliance study which is seriously flawed. The Robert R. Nathan Associates statement, which we have included in the record, analyzes the study in great detail. It concludes that the sampling used in the study for the direct selling industry is not at all representative of the industry.

Moreover, it shows that even using the IRS's flawed data, actual compliance rates, measured as a percentage of taxes paid, approach 90 percent.

This is as high, if not higher, than compliance with many other types of income, including interest, dividends, and self-employment earnings, generally.

Moreover, the proposed withholding system applied to direct salespeople is unworkable. Most direct selling companies do not pay commissions to sales people but operate through buy-sell relationships. There are further substantial numbers of direct sellers who are a part of multitiered sales and distribution systems where goods are bought and sold through three or more more tiers of direct salespeople.

In these circumstances, it would be extremely difficult to determine who should withhold what amounts, on which transactions.

It would be nearly as difficult to the company selling through hundreds of thousands of salespeople whose commissions are the deposits they take when the sales occur. Furthermore, straight commission companies will incur additional administrative costs that are not justified, given the realities of the direct selling industry.

The Nathan study indicates that implementing withholding in the direct selling industry will cost direct selling companies $70 million annually. Yet, given the rate of tax compliance, even as derived from the flawed IRS study, the withholding would only produce a very small increase in revenue, estimated to be less than $30 million.

Thus, withholding is likely to cost direct selling companies much more than it would bring into the Government in increased revenues.

In addition, Mr. Nathan estimates that perhaps 800,000 income opportunities would be lost in our industry alone.

We support S. 736 because it resolves the most important question before the subcommittee—the question of the determination of status of the independent contractor in a reasonable and judicious manner. We urge its approval.

Mr. Beyer may want to make some comments on the methodology of the study.

Mr. BEYER. Very briefly, Mr. Chairman, let me point out that, after very considerable study of the IRS study and an examination of its conclusions and methodology, we have very serious reservations about it and feel the conclusions that have been drawn from it are inappropriate.

Most importantly, the measure of tax compliance that is most meaningful for a fundamental tax change, namely, the percentage of taxes paid to the taxes owed, is indeed very high, on the order of 90 percent.

As an illustration of this, Senator Packwood's reference to it, the de minimis example, taking IRS data itself, 80 percent, four-fifths of those workers who are audited by the IRS show that they had an unpaid tax of $8.12 which raises a serious question about the role of the withholding.

More importantly, there are other dimensions of the measurement of compliance that were inappropriately included, such as the fact that people who did not have to file because they had incomes below that required were excluded from the compliance rate when, in fact, they are indeed compliers and therefore, again representing an overstatement of noncompliance by the IRS.

The design of the study was flawed, as already has been mentioned by Mr. Carlson, in a variety of ways that leads to the conclusion that a nonrepresentative sample was designed in a way to reach a conclusion which we feel is simply not appropriate. Careful examination of that study would show that it ought not to serve as a basis for this tax change.

Senator BYRD. Thank you.

Mr. Lehr?

STATEMENT OF GUSTAV LEHR, EXECUTIVE VICE PRESIDENT, MFA INSURANCE COS., COLUMBIA, MO.

Mr. LEHR. Thank you.

My name is Gus Lehr. I am the executive vice president of the MFA Insurance Cos., Columbia, Mo. I am appearing on behalf of the National Association of Independent Insurers, which has filed a detailed statement with the committee. I have also filed a statement.

Accompanying me, but not testifying, is Mr. Willis Crane, an independent contractor insurance agent from South Carolina who will respond to any questions, should the committee have any of him.

It will be difficult to be more brief than the seven-page statement submitted in view of the unsettling experiences of my companies during the past 7 years, but I will try.

We are convinced—our agents are independent contractors. We always have been. From 1946 to 1972, the Internal Revenue Service agreed. In 1972, the IRS changed its position and alleged our agents to be employees.

By 1974, the gross assessments for allegedly unpaid taxes which we were confident our agents had already paid, was $19,148,000. An additional $9 million for 1975 and 1976 also came into issue.

This sum was required by State law to be shown as a contingent liability in our published financial statements through 1976, which cast a cloud on our company's financial stability. Not until 1977 was the gross assessment abated to $10 million by our obtaining 4669's from our agents, past and present, at tremendous cost. Incidentally, the information contained in the 4669's is readily available to the Internal Revenue Service from its own records.

The IRS has refused to be of help in this respect and we have continued to incur the cost of getting these forms from our agents, in concern of future assessments.

In addition to our agent problem, the Internal Revenue Service held our private pension plan to be discriminatory because our agents were not included in it. As commission paid people, they never were, and should not have been. Not only were our companies taxed additional amounts because of disallowance of business expense deductions allowed as contributions to a qualified plan, but our plan itself made up of employer-employee contributions was assessed over $1 million in allegedly unpaid taxes.

The 1978 Revenue Act has taken care of the past, and for this we are grateful. The future remains in doubt.

I might make mention of the Internal Revenue Service witness' stating that 47 percent of independent contractors do not comply. In the insurance industry, we are proud that 98.3 percent of our people do comply and on the assumption that the people pay for everything, spending more to collect taxes than the taxes collected is uneconomic.

We do not know what the withholding proposals would do to our companies. We not only pay our agents as independent contractors, but we pay literally thousands of other independent contractors in the form of attorneys, physicians, and independent claims adjustors.

Consequently, we urge that the issues of the independent contractor and withholding be kept separately.

In conclusion, Mr. Chairman, I would like to read the last three paragraphs of my formal statement.

Our agents meet the five tests set out in S. 736. They would be independent contractors under this bill. While we are convinced that they are independent contractors under the common law and IRS rulings and regulations and were so treated by the IRS for over 25 years, without S. 736 expensive and protracted litigation will be required to finally establish this.

We urge you to pass S. 736 and end the uncertainty we face. This is not a request for legislation to enable us to create a new, different or more advantageous classification for our agents, but a request to return us to the certainty we had for 25 years before the costly, harrowing experience which began in 1972.

If the Congress should conclude that such a bill cannot be enacted this year, we strongly urge that the relief provisions of section 530 of the Revenue Act of 1978 be extended through December 31, 1980, to permit the enactment of a definitive solution in the next session.

Thank you.

Senator BYRD. Thank you, sir.

Mr. Robert M. Dunville, Sr., Richmond, Va.

STATEMENT OF ROBERT M. DUNVILLE, SR., PRESIDENT, ROBERT M. DUNVILLE BROS., INC., RICHMOND, VA., REPRESENTING THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, WASHINGTON, D.C.

Mr. DUNVILLE. I am Robert M. Dunville, Sr., president of Robert M. Dunville Bros., Inc., a commercial builder in Richmond, Va. I represent the Associated General Contractors of America and wish to submit for your consideration the full testimony and the supporting data attached thereto.

Senator BYRD. Thank you, sir. That will be made a part of the official record.

We are glad to have you today.

Mr. DUNVILLE. I will briefly cover some of the points raised in the testimony.

We emphasize that the purpose of S. 736 is to clarify the status for tax purposes of as many independent contractors as possible so that wasteful and unnecessary litigation and harassment will be eliminated in the future. We also believe a necessary and proper objective of these deliberations would be to provide consistency among the various Federal agencies in their definitions of who is and who is not an independent contractor.

We support the Dole bill, S. 736, and consider the "safe harbor" contained therein as a refinement of the common law control test, and, therefore should be enacted into law.

We feel that the Congress also has a definite responsibility and an opportunity at this time to enact into law a refinement of the economic reality or investment test which is included in section 3508(c) of the Crane bill, H.R. 5266 (see footnote 3). The investment test is based on tax law (see footnotes 1 and 2) and must have equal standing in this legislation in order for the results of these delib-

erations to be rational and scrupulous. We feel the criteria for the two "safe harbors" are apparently incompatible and probably cannot be merged into one. We outline why an owner-operator cannot come in under the Dole "safe harbor" on pages 11 and 12.

We support section 4 in H.R. 5266 which calls for a 4-year study of the impact of this legislation on the tax compliance of the independent contractor and urge its incorporation into S. 736. This study would preclude the immediate, and perhaps permanent, imposition of a withholding tax on independent contractors. Before the Congress enacts a requirement that could force some small businessmen to close shop, it would seem prudent to require a very detailed and reliable study.

We do suggest that report language, regarding the compliance study, instruct the IRS to develop a new, shorter, more efficient reporting form and other information programs to be used in connection with the study, perhaps along the lines of those used for reporting interest income. In this regard, we note the GAO statements that the "IRS needs to be more systematic and vigorous in detecting and pursuing nonfilers," and, "IRS has not taken the action needed to get a good understanding of how many nonfilers exist, who they are, why they fail to file, and what action will prompt their compliance."

We strongly urge the adoption of section 3508(e)(2) of the Crane bill, H.R. 5266, which would preclude the arbitrary and capricious switching of employees to independent contractor. On this point, we are in agreement with the unions.

We emphasize that the public and the Congress should not be deceived by comments that the broad tax evasion problem will be solved by a withholding tax on independent contractors. Even as Senator Bellmon said on the Senate floor, September 10, the recent disclosure "suggests that withholding is the most efficient method for eliminating the problem of noncompliance," but he did not say the disclosure proved it.

We stress that the consumer and the minorities will bear the burden of a withholding tax on independent contractors and/or the failure to define the investment test. In the construction industry the contractor figures each of his elements of cost and arrives at a total cost.

To this total cost he adds a hoped-for profit in order to arrive at his bid to the consumer. His portion of the social security tax plus that of the employee is included in the total cost and is paid by the consumer in an increased contract price for the construction he purchases.

In fact, when social security taxes are raised, many employers increase their workers' pay so that the take-home pay is not reduced. The consumer also pays this added cost. This is pure and simple economics and nowhere is it more obvious than in the construction industry.

We note that enactment of the investment test would protect well over one-quarter million owner-operators of trucks of whom approximately 20 percent are nonwhite. The recognition of owner-operators generally would be a very appropriate move for the Federal Government in view of the high profile which Congress has given to minority business enterprise, particularly in the construc-

tion industry. The route provided to owner-operators of equipment is one of the most common ways in which small businessmen, including minorities, have been able to make successful entrances into the construction industry.

We urge the listing of the 20 common law factors (see footnote 5). These can appropriately be included in section 3508(f)(2) of the Crane bill and the identical section of the Gephardt bill. The Dole bill does not have this section, but all of these provisions and the common law factors should be included in S. 736. This will preclude the IRS from at some time in the future reducing the scope of the general common law definition of independent contractors not in "safe harbors." Ideally, if Congress could comparatively weigh these factors now, all independent contractors would be in a "safe harbor." This would completely eliminate unnecessary harassment and litigation which, as we understand it, is the ultimate goal of this committee and the Congress.

Senator BYRD. Thank you.

Mr. James M. Bodfish, president of Tax Executives Institute, accompanied by Mr. Charles L. Dunlap, chairman, Subcommittee on Employee and Independent Contractors, are also present.

STATEMENT OF JAMES M. BODFISH, PRESIDENT, TAX EXECUTIVES INSTITUTE, INC.

Mr. BODFISH. Mr. Chairman and members of the subcommittee, I appear before you today in my capacity as president of the Tax Executives Institute.

Tax Executives Institute, Inc.—TEI—is an organization with approximately 3,250 individual members representing 1,800 of the largest corporations in the United States and Canada. Membership in TEI consists of persons employed by corporations and other businesses who are charged with the administration of the tax affairs of their employers in an executive, administrative, or managerial capacity.

Tax Executives Institute, Inc., is dedicated to the principle that administration of and compliance with tax laws in accordance with the highest standards of professional competence and integrity in an atmosphere of mutual trust and confidence between business managements and tax administrators promotes uniform enforcement of taxes and minimization of the cost of administration and compliance to the benefit of both Government and taxpayer.

One of the stated purposes of TEI is "To cooperate with Government tax administrators in meeting and solving problems of tax administration."

TEI appreciates this opportunity to submit its position and comments on legislative proposals to clarify the rules governing the classification of workers as either employees or independent contractors for Federal employment tax purposes and in particular S. 736.

TEI agrees with the statement in the introductory paragraph of the GAO report that the key elements of an efficient tax system are that the tax laws be clear, unambiguous, and not subject to arbitrary interpretation. The importance of these principles as applied to payroll taxes is underscored because many millions of tax dollars are involved.

TEI agrees completely that a problem does exist and applauds the efforts of the Congress in seeking a solution. As noted above, there are difficulties in making the determination of who is an employee and who is an independent contractor. TEI members are very much concerned about the harsh results of making an error in this classification. When it is determined that persons have been misclassified as self-employed when they were in fact employees, the following consequences ensue:

One, the employer can be assessed retroactively employment taxes for all open tax years—at least 3—including penalties. Worse, he does not have available the procedures allowed in income tax cases, whereby he can contest the assessment prior to payment. Even if he can arrange for the litigation to cover only a token employee, liens may be placed against his business for the total sum, seriously impairing his credit. In fact, this procedure seems to be required by IRS Manual Supplement 5547. Sadly, the situations where this is done are likely to be those in which the alleged employer is in the worst position from the standpoint of survival.

Two, double taxation can occur when the employer and employee pay income and social security taxes on the same income. IRS is not allowed to offset self-employment payments under FICA unless the employee is prevented by the statute of limitations from filing for a refund and in no event is the alleged employer allowed to offset the excess of the self-employment payments over the amount of the employee FICA assessed.

Three, self-employment retirement plans established by individual taxpayers will be declared invalid and, even more significant, the qualification of the alleged employer's pension and profit-sharing plan may be placed in jeopardy because the addition of a significant number of people to the employee category may cause a failure to meet a safe-haven statutory participation test.

Broader economic consequences are involved. Although not as immediate and direct, they are nonetheless serious, because they tend toward a constriction of economic activity. For example, if a merchandising firm relying on independent sales agents is required to assume a greater burden on account of those agents by having to treat them as employees for tax purposes, then that firm is likely to be less liberal in its selection of the personnel to whom it offers the salesperson opportunity. In short, fewer people will be employed in such activities. As another example, if firms are required to assume the burdens as employers for tax purposes, then they logically will choose also the benefits of the employer status. Thus, people who otherwise might have operated as independent businessmen will tend to become instead employees of major companies, thus significantly reducing the number of entrepreneurs. A still further example is the independent businessman who has availed himself of Federal benefits applicable only to small businesses, including loans, advisory services, et cetera, upon being reclassified as an employee, would lose those benefits.

The complexity of the problem and the seriousness of these consequences have been recognized by the Internal Revenue Service. Indeed the Commissioner himself in his remarks to the Tax Section of the American Bar Association on August 6, 1977, stated the following:

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Revenue Rulings have been of little help in solving the problem. Currently, there are 282 published Revenue Rulings relating to the employer-employee relationship. In 1974, approximately 374 private letter rulings were issued in this area. Court decisions often conflict among themselves and with the rulings.

If the prohibitions of section 530 are allowed to expire, audit activity and proposed assessments will again rush forward notwithstanding the recognition given the gravity of this problem by Congress when considering the Tax Reform Act of 1976, and the Revenue Act of 1978. On September 13, 1976, the conferees urged the IRS to refrain from further aggravation of the situation in the following terms:

Because the status of individuals as independent contractors or employees for Federal tax purposes presents an increasingly important problem of tax administration, the conferees agreed to join in the request of the Senate Finance Committee (S. Rept. 94-938, p. 604) that the staff of the Joint Committee on Taxation make a general study of this area. The conferees also join in urging the Internal Revenue Service not to apply any changed position or any newly stated position which is inconsistent with a prior general audit position in this general subject area to past, as opposed to future taxable years until the requested staff study has been completed. Thus, the conferees agree with the statements on this aspect of the subject in the Finance Committee's Report (S. Rept. 94-938, p. 604), as amplified by the Chairman and ranking member of the Finance Committee on July 26, 1976, during consideration of H.R. 10612 by the Senate.

The July 26, 1976, statement incorporated into the committee report by reference reads as follows:

The committee did not intend to limit itself to retroactive revenue rulings but intended to include positions taken in good faith by taxpayers, which, under general administrative practice, the Service has allowed to stand. The committee intended to urge that any changed position be applied on a prospective basis, at least for the time being. This would be true if the new position is reflected in a published revenue ruling, a private ruling, or a change in what had been, for a long while, the accepted, audited practice in an industry.

On August 23, 1978 the statement from the Congressional Record reflects the following:

Beginning in the early 1970's, however, the Internal Revenue Service began to rescind a long standing rule in this area and to adopt new and harsh interpretations of the common law in audit procedures. This produced great confusion in what had been a reasonably well defined area.

Assessments involving millions of dollars have been made or proposed, and several businesses have ceased operations as a result. Millions of income-earning opportunities are threatened. These adverse consequences were confirmed in recent testimony before the Subcommittee on Taxation and Debt Management where several witnesses testified to the devastating economic consequences to small business resulting from these retroactive assessments.

Mr. President, the widespread alarm resulting from the actions of the Internal Revenue Service was recognized by Congress, and the Internal Revenue Service was urged in the conference report accompanying the Tax Reform Act of 1976 to 'not apply any changed position or any newly stated position which is inconsistent with a prior general audit position in this general subject area to past, as opposed to future, taxable years' until the completion of a study of the problem by the staff of the Joint Committee on Taxation Despite this urging, testimony before the Subcommittee on Taxation and Debt Management made clear that the IRS has continued to rescind long standing rules and to adopt new and harsh interpretations of the common law.

Mr. President, this issue is enormously important. The Commissioner of Internal Revenue recently has indicated that:

"At the present time in two districts of one region alone, there are three potential assessments against taxpayers ranging from $6 million to $60 million, involving an insurance company, an oil jobber, and a direct sales company."

He has also stated that:

"There are situations where assessments exceed a taxpayer's net worth by a considerable amount. Furthermore, testimony before the Committee on Finance

Subcommittee on Taxation and Debt Management has indicated that taxpayers have already been driven out of business by IRS employment tax assessments based on reclassifying individuals as employees even though they had long been considered by all to be independent contractors. Given these dire circumstances, it would be wholly inequitable to continue for another year to subject taxpayers to the confusion and uncertainty which now exists in this area of the tax law."

Further in the Congressional Record of the same date, the following appears:

One can understand why the Treasury for purposes of effective administration, would like to make employers do the withholding and do the bookkeeping so they can more effectively collect their money.

But on the other hand, it is a great big burden on behalf of taxpayers to have to do all of that, so you and I if we were in the real estate business and we had people working for us would much prefer not to fool around with that and let them do their own accounting with Uncle Sam. But Treasury would like to make us regard these people, whom we choose to regard as independent contractors, as our employees so they can make us withhold and account for it and do the bookkeeping for the Treasury.

As can be seen from this colloquy, clear, concise legislation is necessary to insure that the Internal Revenue Service stays within the boundaries intended by Congress. Expressions of intent by Congress will not corral the overly enthusiastic audit activities of the Internal Revenue Service.

Thus, we have the IRS primed and ready to again pursue a vigorous enforcement procedure in an area where distinctions are difficult to draw in the face of congressional admonitions to the contrary and with serious consequences for perhaps well-intentioned taxpayers. To ameliorate this acute aspect of the problem, legislation is needed to temper the IRS pursuit to fill the Federal coffers after the expiration of section 530. Such tempering should be in the terms of S. 736.

TEI formed an ad hoc committee in 1977 to study this problem in depth. Membership on this committee has involved representation in practically every major industry group in the United States. We believe that this multi-industry participation is important because the comments and suggested solutions are not dominated by the desires of any one particular industry group. The committee has had a number of meetings internally as well as with representatives of the Department of Treasury and the staff of the Joint Committee. From these extensive discussions, there has evolved four basic principles which we believe should serve as a guide to analyzing the situation and developing a solution. These four principles are:

One, the provisions of S. 736, with only minor modifications, will provide the solution necessary to enable the Government to collect the proper tax due without imposing an undue burden on corporate taxpayers to handle administrative and collective matters which properly belong with the Internal Revenue Service.

Two, the criteria for determining whether a worker is self-employed or an employee under the common law should continue to be an alternative which is available to taxpayers if the "safe-haven" provisions of S. 736 are not applicable. It is crucial that no action be taken, legislatively or administratively, which would jeopardize the many areas of nontax questions which presently, under existing law, find their solution by resolving the question of whether or not the individual is a common law employee or an independ-

ent contractor. Such areas would include unemployment, unionization, workmen's compensation, liability for actions, and those related to other tax areas.

Three, the consequences of misclassifying a person as an independent contractor are so harsh that a procedure such as that prescribed in S. 376 should be available whereby requirements are set forth which, if they had been met, would provide a "safe haven" for taxpayers to protect themselves from retroactive assessments. Without these "safe haven" provisions, taxpayers can be, and very often are, lulled into believing that their actions are acceptable to the interpretation of the Internal Revenue Service when subsequent interpretations have the far-reaching effects of causing severe financial hardship upon corporate taxpayers.

Four, the legislative provisions should include the necessary reporting requirements to assure compliance with the tax laws by independent contractors.

TEI is of the opinion that S. 736 could be improved, equitably, if three provisions were added.

One, the first would be accomplished by adding a new subparagraph (d) to correspond to the language in H.R. 3245, to wit:

(d) *No Inference.*—If all the requirements of subsection (b) are not met with respect to any service—

(1) nothing in this section shall be construed to infer that the service is performed by an employee or that the person for whom the service is performed is an employer, and

(2) any determination of such an issue shall be made as if this section had not been enacted.

Two, the second would be accomplished by granting Tax Court jurisdiction to employee tax disputes so that taxpayers could litigate any controversy without having to first pay the taxes in dispute and ultimately suing for a refund. The jurisdiction which is presently vested in other courts could continue in their present posture.

Three, a third equitable improvement to S. 736 would be accomplished by adding a provision requiring the Government to offset already paid self-employment taxes against any alleged liability of the corporate taxpayer. Quite often it is impossible for the corporate taxpayer to establish, to the satisfaction of the Internal Revenue Service, that the individual has already paid self-employment taxes and therefore a collection of the employment taxes from the corporate taxpayer would be a double collection of the taxes in question. If the corporate taxpayer furnishes the Internal Revenue Service the taxpayer identification number of the payee, the Internal Revenue Service should use its resources to determine the amount of self-employment taxes already paid by the individual.

As we have said before, TEI very strongly recommends retention of common law test as an alternative to any legislative solution to this tremendous problem of determining whether a worker is an employee or self-employed independent contractor. Furthermore, if the provisions of section 530 of the Revenue Act of 1978 are permitted to expire, we recognize that the situation will deteriorate back into one of chaos and injustice similar to that which existed prior to the enactment of section 530. TEI believes that the enactment of S. 736 will provide a practical solution in giving the business com-

munity the framework which it needs to operate so that there is no longer the exposure to huge liabilities from alleged past noncompliance by a revenue agent who enters a business in which he is quite often not familiar and attempts, several years subsequent to the event, to second guess management as to whether certain vague and uncertain events might have occurred to which the revenue agent can point and make the accusation, very often without any foundation, that such action is sufficient to make the individual an employee instead of an independent contractor.

The requirements under S. 736, which must be met with respect to service performed by the individual, are adequate to prevent an abuse of the relationship. If a long list of elements is used to determine whether or not necessary control is present to make an individual an employee, the parameters are so broad that abuse by the Internal Revenue Service can readily exist whereby the Internal Revenue Service could deem that control does exist. Probably no relationship exists without some infringement of the 20-factor criteria. With the requirements proposed in S. 736, the uncertainty or vague areas governed by subjective opinions and measurements would be avoided by the use of four objective tests which should present little dispute as to whether or not they have been fulfilled.

TEI members believe that while S. 736 in its present form would solve the questions and lay to rest the uncertainties in most of the industries represented in TEI, in addition to the three mentioned above, there are a couple of minor changes which TEI feels could be made to S. 736 which would make it a more effective solution. Consideration should be given to changing S. 736 as follows:

One, at the end of section (b)(3)(B) of the bill a new subsection (C) should be added as follows: "(C) The retention of service lacks assurance of continuity."

It is felt that longevity, or the like thereof, of the relationship should be an alternative to the investment and risk of income fluctuation since some independent contractor relationships are of a short, one-time duration and there might not be any substantial investment and there might not be any risk of income fluctuation.

Two, the title of section (3) would have to be changed to reflect the addition of section (C) discussed immediately above.

Three, that subparagraph (b)(4)(B) should be revised by changing the last portion to read, in part, as follows: "* * * contract is executed, that it is his responsibility to pay self-employment and Federal Income Taxes."

It is felt that the present language is too broad in that it could easily be interpreted to mean that the company must give the independent contractor tax and legal advice regarding his taxes. This, of course, companies are prohibited from doing. The objective is to be sure the independent contractor knows he, and not the company, is to be responsible for the timely and proper payment of all taxes.

Four, since this issue often involves huge sums of money and often threatens the very solvency of the company, consideration should be given to adding a provision to grant Tax Court jurisdiction to cases involving employment taxes. In this way, if the issue cannot be resolved without litigation, the taxpayer can litigate the issue without first paying the taxes in dispute and filing a subse-

quent claim for refund followed by a suit for refund. It would indeed be a grave injustice perpetrated by the tax system if a taxpayer had to first face bankruptcy to be entitled to litigate the tax issue and then have a court decision stating that its position, and not that of the Commissioner, was correct. TEI presently sees no reason to take jurisdiction away from other courts, but merely is suggesting adding the Tax Court to the courts to which the taxpayer can seek a remedy.

Five, to prevent the double collection of taxes, TEI believes that a provision should be added to require the Government to check the Government records and allow an offset against the alleged liability of the company for all employment taxes paid by the person who was believed to be an independent contractor. It is essential that the Government be required to check its records and not require the company to obtain signed statements from the workers since, quite often, the workers are no longer associated with the company and obtaining statements from them is impossible. Also, if the worker is still associated with the company, there is a question of the propriety or legality of the worker giving the company a copy of his tax return. The Government has this information, and if the company furnishes the identification number—social security or employee identification—to the Government, the company should be allowed an offset of all employment taxes paid by the worker without the company being required to contact the worker for proof of the amounts he paid as employment taxes.

TEI believes that not many taxpayers are likely to ignore their tax liabilities if the provisions of S. 736 are enacted and, as to those who might, the means are provided to bring them to justice. Even though TEI has been unable to substantiate the position of the Internal Revenue Service that there is significant noncompliance by independent contractors, we see no reason why the provisions of S. 736 would produce any less compliance than presently exists in the case of employees. Corporate taxpayers presently file 1099's with the Government. The Government has some obligations to take information which it has and verify whether or not the independent contractor actually reports the sums which are reflected on the 1099's. Since the Internal Revenue Service apparently, continually fails to use the resources at its disposal, TEI is at a loss to see why any change should be made unless Congress concludes that the complete administration of tax collection should be yoked to the corporate community, serving as an albatross, in an effort to improve the collection of revenue and the administration of the Federal tax laws. Maybe the Internal Revenue Service intends to make an effort in this area. The effectiveness of the IRS's new 1099—NEC should be studied in a couple of years to determine if there has been any change in compliance by independent contractors.

With such a system in place, the problem of classification would lose significance, and, along with it, the concern about manipulating the arrangement between the parties to produce an independent contractor categorization. The reasons for the concern would no longer exist. The GAO report and the joint Treasury and IRS response speak in terms of an IRS bias against, and taxpayer incentive for, the categorization of independent contractor. But

these adverse interests exist only if one assumes noncompliance on the part of the independent contractor. If there is substantial or full compliance, the Government will collect the appropriate revenue. The GAO report on page 12 points to the fact that self-employment tax was 7.9 percent, now 8.1 percent, whereas the combined employer-employee rate was 11.7 percent, now 12.2 percent. But these rates fail to take into account the deductibility for income tax purposes of the employer portion of the tax, which in most cases bring the two situations very closely into equilibrium.

The Treasury's proposal as presented to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on June 20, 1979, does not address the problem facing this committee of clarifying the method of deferring the status of workers as independent contractors or employees. While the testimony of the administration on June 20, 1979, contained results which were attention-getters on first sight, a further analysis and a more indepth consideration of the testimony brings one to the realization that the testimony does not support the drastic actions proposed by the administration. In fact, TEI sees no basis for giving recognition to the present administration assertion of high noncompliance than the GAO gave the earlier assertions of the IRS.

The administration asserts that the alleged "noncompliance diminishes public respect for the operation of the tax system and jeopardizes our system of voluntary compliance. Moreover, such conduct is patently unfair to honest taxpayers who must, as a result, bear a large share of the tax burden." This is probably the crux of the entire problem which has mushroomed in the Internal Revenue Service. Public respect for the operation of the tax system and whether or not the system of voluntary compliance will be jeopardized will not turn upon the noncompliance alone. The loss of public respect and the jeopardizing of the system will result when the administration fails to perform its obligation of enforcing the tax laws by failing to enforce the existing tax laws and the compliance necessary through the existing enforcement provisions of the Internal Revenue Code. The unfairness to the honest taxpayers results from the failure of the Internal Revenue Service to properly prosecute the noncompliance cases. If the Internal Revenue Service prosecutes to the fullest extent permissible under the existing law, the 47 percent of workers who reported no compensation for income tax purposes and the 62 percent which paid no social security tax, it is reasonable to believe that the compliance in the various categories of independent contractors will, as a result of such prosecutions, increase drastically.

Next, the administration attempts to show the unfairness of the self-employment contributions to Self Employment Contributions Act—SECA—when compared to the Federal Insurance Contributions Act—FICA. What the administration fails to point out in their analysis of the diverse percentage due is the fact that the portion paid by the employer—one half of the FICA tax—is deductible by the corporation from taxes it must pay with the net result being that the SECA and FICA have an almost equal net effect on the taxes collected with the net effect being the transfer of revenue from the general fund to the social security trust fund. Finally, the administration's introductory comments are based on the ill-found-

ed conclusion that noncompliance is the "root(s) of the employee-independent contractor problem." It is the failure of the administration to properly enforce the existing tax laws through prosecuting those who fail to comply. In fact, it is this failure to prosecute that is the root of the employee-independent contractor problem. This, in turn, fuels the disporportionate tax burden placed upon honest taxpayers and the loss of public respect for the voluntary tax system.

Tax Executives Institute supports 100 percent the goal of the administration and the Congress, since we also desire to prevent noncompliance by independent contractors or any other taxpayer; however, we do not agree with the administration that the only effective way to achieve that goal is with a system of withholding tax from compensation paid to independent contractors. As we have said earlier, proper enforcement of the present compliance provisions in the Internal Revenue Code will, in our opinion, achieve that goal, at least, to the extent which the administration believe withholding will improve compliance.

There is no basis for the administration's proposal that a flat rate of 10 percent be withheld from payments since, obviously, this might or might not correspond with the taxable income of the individual after deducting all appropriate deductions from the gross sums received. Apparently the administration is seeking to force compliance from those receiving small sums of money, since the higher the gross income the higher the compliance rate. If that, in fact, is the objective of the administration, it has laid the groundwork for defeating its own objective by permitting any individual, whether they work for five or more payors or opt to elect out of the withholding system, to escape the mandatory withholding. The results of the Commissioner's study itself supports the conclusion that the largest number of payees will escape withholding under the administration's proposal if there are any exceptions made to the withholding system.

With reference to the administration's proposal to narrow the rate of tax due between FICA and SECA, Tax Executives Institute feels this is a very worthwhile objective, even if there is very little, if any, difference in the rate, since, as discussed above, the payor is permitted a deduction for the payment it makes under FICA with the net contibution to the social security trust fund for FICA and SECA being very near, if not equal to, each other.

The administration's proposal to apply a penalty tax of 10 percent of the amount of wages not withheld upon is meaningless—the abatement would be based upon whether or not it was "reasonable for the payor to conclude that a worker was an independent contractor"—since the entire present problem finds its genesis in a difference of opinion between the Internal Revenue Service and payors as to whether or not is was "reasonable for the payor to conclude that a worker was an independent contractor." If the Internal Revenue Service uses its present reasoning for determining whether or not something was "reasonable," the present problem will continue as the Internal Revenue Service attempts to assert that the payor was unreasonable in treating the worker as an independent contractor.

In dealing with the problem, the administration continues to confuse the "problem" with the "symptom" as it addresses this question. The "problem" is not the noncompliance by workers to the payment of tax—it is the "symptom" which results from the true "problem" with the problem being the administration's failure to properly enforce the present laws. The administration is to be applauded for its concern about retroactive assessments. The sincerity of the administration's concern will be shown by how responsive it is to pursuing the appropriate person responsible for the nonpayment of taxes—that being the independent businessperson who fails to pay the appropriate tax and not how it pursues the payor who makes the payments and properly reports such payments to the independent businessperson and Internal Revenue Service. Under the reasoning of the administration, any underpayment of tax by a payee should be corrected by an assessment against the payor. This reasoning is incorrect even if the payee is an employee. No interpretation of the Internal Revenue Code supports such a conclusion and, likewise, none supports the interpretation given by the Internal Revenue Service that the nonpayment of tax by an independent businessperson is the responsibility and liability of the payor.

With reference to the IRS study, one must observe that, even with the clout enjoyed by the Internal Revenue Service, they were able to reach less than 80 percent of the workers they attempted to audit. This highlights a point payors have been making during the recent audits by the Internal Revenue Service. When attempting to verify whether or not the payee paid the appropriate income and Social Security taxes, payor taxpayers quite often were unable to receive any response from former payees and, in fact, from some present payees. When payors were unable to make absolute verification for the Internal Revenue Service, the Internal Revenue Service refused to permit payors credit for any taxes which might have been paid by the payees. Even though the Internal Revenue Service study shows that 47 percent of the workers reported none of the compensation in question, it does not show how much was not reported from a dollar point of view. While an independent businessperson may perform a service and be compensated $15, that person would be part of the 47-percent statistic of the Internal Revenue Service while the dollar amount would be very minimal if compared to the other income which the individual reported on his income tax return. Therefore, without complete details of the Commissioner's study, it must be concluded that, even if the sampling was unbiased, the results are extremely distorted when looking at the tax actually paid by a given individual. The statistics from the IRS study do not show, for example, how much tax was reported on the adjusted gross income of the various categories which the Commissioner used since the report only shows the percentage of income from self-employment which was not reported, and there is no apparent correlation between the income from self-employment and the adjusted gross income categories used. This is important since a distortion of these tables result if an individual is both self-employed and an employee for another payor and reports wages received as an employee but does not report self-employment income. To be meaningful, the IRS survey would have to show the

difference between adjusted gross income reported and adjusted gross income not reported for a total of adjusted gross income subject to taxation.

Likewise, there is no correlation between the percentage of compliance for instances where 1099's were furnished when 1099's were not furnished.

TEI takes issue with the administration's treatment of payees whom the IRS were unable to locate. The IRS dropped these from the sample and concluded that they would have increased the noncompliance vote since they involved small sums. TEI is of the opinion that, if they could not be located, the conclusion should be reached that there was 100 percent compliance since the sums were so small that probably no tax was due.

Also, TEI is unable to see why the 4.7 percent, determined to not be liable for tax, was eliminated from the study instead of considered complying 100 percent since they paid all tax due, even though none was due, and thus satisfied the compliance provisions.

The administration's highlighting of another problem again is not the problem itself but is a result of the problem. The fact that an individual is depriving himself of social security coverage if he does not pay his social security tax is not the problem but is the result of the problem of the Internal Revenue Service not enforcing the compliance laws it has with reference to social security taxes.

It is the administration's failure to force compliance with Internal Revenue laws and not the evasion of taxes themselves which place the unwarranted burden upon other taxpayers. The administration is correct in stating that "we simply cannot expect honest taxpayers to tolerate proven, large-scale avoidance of taxes by others," but it is the administration's responsibility to enforce the existing compliance laws to the satisfaction of these honest taxpayers that the administration is not doing and thereby promoting and tolerating large-scale avoidance of taxes by others.

The administration has eluded to the real argument which has surfaced in this question. Whether or not an individual is an independent contractor is not the issue as far as the Internal Revenue Service is concerned because it has finally recognized that the status of the individual is such that "in fact, it has no direct relationship to whether workers should be subject to withholding." What the administration would like is to impose certain aspects of the employee status upon independent contractors in an attempt to relieve the administration of its obligation to administer the Federal tax laws. TEI very strongly disagrees with the administration's statement that "the presence or absence of control has little to do with whether a worker should be subject to withholding—or, for that matter, to higher premiums for social security benefits"—since it is the control question which determines whether or not an individual is an independent contractor and, if the individual is an independent contractor, that is the sole criteria to be used to determine whether or not the workers should be subject to withholding. If there is no control, there should be no withholding.

The administration recognizes that withholding has far-reaching connotations when its own proposal states that they would provide an exception to their 10-percent withholding proposal which would "help assure the existence of a continuing relationship between the

payor and the worker." If, in the administration's mind, the lack of withholding helps assure the existence of the independent contractor relationship, the converse must be true in that withholding would, itself, connote that the relationship was one of employee and employer. There are far-reaching repercussions—unemployment, unionization, pension plans, workers' compensation—once the relationship deteriorates to an employee/employer relationship instead of the intended independent contractor relationship.

If there are as many large-scale tax cheats and frauds as the administration would have us believe, it is difficult to understand how the administration will catch these individuals if the payees opt out of the withholding system by signing the necessary forms and submitting them to the payor. The Internal Revenue Service would have no more to begin the audit of these individuals than it presently has under the nonwithholding system.

For the administration to assert that "the additional costs associated with flat-rate withholding should not be significant" since the payors are presently filing information returns, is entitled to as much consideration as saying that the cost to the Internal Revenue Service to check information returns would be insignificant since it presently checks W-2 returns for matching purposes and audits. Likewise, the administration's assumption that the payor's use of the withheld tax money pending payment would offset these costs is ill-founded since it assumes all taxpayers have expert investment counsel—most do not—and that all of the money would be invested every hour that it was in the payor's hands. The fallacy of the Government's reasoning here is obvious as is its reasoning that "withholding is a simple and relatively painless way to pay taxes when compared to budgeting for large estimated tax payments." The worker's use of the money during the interim may very well offset any pain experienced from budgeting for the subsequent tax payments.

With reference to the withholding on salespersons whose compensation is based upon the difference between the purchase price and the sales price of merchandise, it is impossible to determine the taxable year in which merchandise will be sold which is purchased by the salesperson. There would be a grave injustice perpetrated upon taxpayers if the purchaser was taxed via withholding at the time the item was purchased for resale when he might not realize any profit, if any, until a subsequent tax year when he actually, in fact, resold the merchandise. Also, it is grossly unfair to base the withholding upon a suggested selling price when, for competitive or other reasons, the salesperson may sell the item for considerably less than the company estimated.

The administration is correct in its assumption that "information reporting can never replace withholding as a means of achieving satisfactory compliance." What the administration fails to say in support of this entire area is that withholding itself will not achieve satisfactory compliance if there is no enforcement of the compliance laws. This is the key to this entire area—there must be compliance of existing laws if the Internal Revenue Service hopes to have satisfactory reporting. Without enforcing the present laws of compliance, the Internal Revenue Service can never hope to have any achieving of a satisfactory compliance rate. What the

administration is conceding by the statement that their efforts would require millions of phone calls, letters, and visits involving compliance is that the administration wants corporate taxpayers to assume its duty of administering the federal tax laws so that the responsibility will be drastically lessened upon the administration to enforce the existing compliance laws. Maybe the administration's concern is that it does not want to assume the ill will connected with enforcing compliance and would much rather that stigma be placed upon corporate taxpayers by the citizenry of the United States. The administration would like for us to believe that it cannot enforce the tax laws because it would be uneconomical to do so, but it would desire that corporate taxpayers assume that responsibility regardless of how economical or uneconomical such might be to the corporate taxpayer. There is a limit to how much corporations can do to perform functions for the Government.

If the administration's ill-founded reasoning is recognized for what it has for its basis, one can readily see that a system of reporting, matching, and strict enforcement by the Internal Revenue Service is much preferred to a hybrid system of withholding on non-employees. This is especially true since the administration admits, in its testimony, that even its proposed system of withholding will not reach a number of workers and, itself, proposes a method of treating such payments to nonemployees. TEI supports the administration's proposal requiring information returns for all payments paid to independent contractors. TEI likewise supports the administration's proposal to increase the penalties upon payors for not reporting such payments on information returns.

TEI believes that this strengthening of the information reporting requirements, coupled with strict enforcement of the compliance provisions of the code, will reach the objective of increasing compliance without the necessity of a hybrid withholding procedure.

TEI agrees with the administration that true common law employees should not be treated as independent contractors and escape the graduated withholding provisions applicable to common law employees. TEI must also voice an opposition to treating true independent contractors as common law employees and, thus, subject to withholding as the administration would desire. Certainty can be given to this area, contrary to the belief of the administration, without sweeping all common law employees into the independent contractor camp. The administration is correct in its statement that changing an individual from one category to the other will have far-reaching effects upon other areas of the law, such as state unemployment compensation coverage, and the estimate of costs to payors if all of the other areas of law deem the individuals an employee are gargantuous.

The administration's interpretation of S. 736 is incorrect. S. 736 would not place increasing numbers of workers outside of the existing withholding system but would make clear the area where true independent contractors would not be subject to withholding and thus would not be treated as employees. It adds stability and clarity to an area of law that has been confused, cloudy, and in a state of chaos for years. Its application of clear, concise criteria which are to be met if an individual is to be treated as an independent contractor instead of an employee will add reason and

fairness to this area of the tax law. True employees could not meet the requirements of S. 736 since it is intended to be applicable only to covering and giving relief to truly independent contractors.

The fact that S. 736 is worded in such a way that it reaches "workers in all of the industries in which there have been disputes as to employment status," verifies the fact that S. 736 grants the needed relief to the areas which need relief. This recognition by the administration highlights the fact that S. 736 hits its target by recognizing independent contractors to be independent contractors and employees to be employees and does not confuse and commingle the two in such a way that they are all treated like either employees or independent contractors.

The administration seems extremely concerned about such areas as State unemployment compensation when it makes the argument that the loss of employee status to an individual would mean that he would also lose the State unemployment compensation coverage but refuses to recognize the importance of the reverse treatment if the individual is changed from an independent contractor to an employee as the administration desires. The administration's no-cost argument for withholding very carefully avoids the repercussions to payors of the worker being deemed an employee for all purposes, not just Federal withholding and social security tax purposes.

Without knowing more about the study, TEI is unable to comment upon the legitimacy or effectiveness of the sampling and whether or not the results are representative of each category. It does appear as though there are substantial numbers of categories resulting from the relatively small sample producing the results in question.

If the administration submits additional testimony to this subcommittee as part of its consideration of S. 736 TEI would like to have the opportunity to submit additional comments in response to any testimony by the administration.

In summary, TEI very strongly supports S. 736 and does not support the administration's proposal of withholding since, it is the opinion of TEI, compliance with Internal Revenue Service laws can more fairly be achieved by the enactment of S. 736 and strict enforcement of the existing compliance laws instead of from a withholding system, which, at best, the administration admits would correct only 60 percent of the alleged underreporting at which it is aimed.

Tax Executives Institute, Inc., very much appreciates this opportunity to make its members' concerns and proposed solutions known. Even though the IRS and Treasury refused to make known their official position on this question for well over 1 year—despite taxpayers revealing their position and soliciting the Government's position, TEI is prepared to meet with the members of the Joint Committee on Taxation, the staff members of the Joint Committee, representatives of the Treasury Department including the Internal Revenue Service personnel, members of the Government Accounting Office staff, and any other appropriate group to further the search for a solution to this situation. We applaud your efforts and courage in attempting to find a solution to this difficult problem. If

Tax Executives Institute can be of any assistance, we will be more than happy to cooperate in any way we can.

Thank you very much for your time and attention.

Senator BYRD. Let me ask this question, if I may. Does the Treasury's proposal—first, let me say this.

As I understand it, the Treasury no longer seeks to redefine independent contractors but instead proposes that the independent contractors so identified in the past and presently remain independent contractors, but that a 10-percent withholding be applied.

Does that appear to be a reasonable proposal?

Does the panel feel that?

Mr. OFFEN. Mr. Chairman, the Direct Selling Association strongly feels that withholding is a draconian solution to a problem that can be met in much less onerous ways and certain portions of the bill before you would put burdens on the business communities, but the burdens we think that the business community should meet, to meet any alleged compliance problem.

In addition, it should be pointed that withholding is an employment concept and is psychologically harmful to the independent contractor relationship, the sensitive relationship between corporations and independent contractors, such as exist in my industry.

Therefore, we do not think it takes into consideration a very significant economic reality approach, while limited in nature to a tax approach. The economic realities of the situation and relationships between the people would be very severely hurt by withholding.

Furthermore, no consideration or insulation is given to protecting various independent contractors, corporations who use independent contractors, from State unemployment compensation, State statutes, franchising laws in various States, doing business with State income tax. No recognition is made of this although it would have that type of an effect, in our opinion.

Mr. CARLSON. Senator, I would like to emphasize the point that, with many categories of independent contractors, the cost to comply with the new reporting requirement would be 10 times the additional tax receipts that the IRS could expect. I think that this is the height of bad policy because costs are imposed so heavily and there are very few benefits in terms of increased taxes due to the government.

Mr. LEHR. Without resolving the independent contractor-employee issue, there has been no resolution of the problem at all. My companies have been in protracted litigation over the past 7 years over this very issue, under common law. After having been treated as independent contractors for 25 years, the IRS position was changed. There would be no assurance without this legislation that we would not be faced with the same problem in the future.

As I earlier stated in my testimony, we do not have any idea of what withholding would cost us, but with 98 percent compliance already in this industry, any cost would certainly be greater than any additional tax revenues that might be derived.

Mr. DUNVILLE. Mr. Chairman, from the standpoint of future definitions, we support two safe harbors and the listing of the 20 common law factors which can be properly included in section

3508(f)(2) of the Crane bill and the identical section of the Gephardt bill.

The Dole bill does not have a no inference section, but all of these common law factors should be included in S. 736 as one cannot predict what Treasury will do. If you would include these additional factors, we think it would enhance the no inference section.

Senator BYRD. You could live with the 10 percent?

Mr. DUNVILLE. YES.

Mr. BODFISH. The Tax Executives Institute feels this procedure is excessively burdensome in terms of the problem at hand, that initial steps should be a reconciliation of the tax forms filed with the IRS and a better audit procedure there.

Senator BYRD. Thank you.

Mr. CRANE. According to the chart, your larger commissioned agents pay 100 percent of their taxes, and the suggestion that you withhold 10 percent and let our company keep it and invest it at interest, you are talking about my money, you understand.

When you are going to get it anyway, it seems to be somewhat of a waste, I think.

Senator BYRD. Let me ask one additional question, then I shall yield to Senator Dole.

If there is a problem of underpayment of taxes by independent contractors, and the Treasury claims that there is, what steps could this panel suggest to bring about appropriate compliance?

Mr. CARLSON. In the first place, Mr. Chairman, the IRS has readily admitted that it does not audit very extensively in this area because they think the returns from additional taxes does not merit that kind of audit increase.

In the second place, they do not audit the 1099's which are submitted annually, and that could be a useful tool for them to gain additional compliance. At some point down the road, you might even require that the 1099 be submitted to independent contractors, which is often done on an informational basis but is not required, and perhaps they could attach it to their income tax forms.

Clearly, the steps that the IRS proposes are an overreaction to a much smaller problem.

Mr. DUNVILLE. I would like to correct an impression I may have left a moment ago, that we would concur with the 10 percent. We do not. A withholding tax is not the solution to the problem and A.G.C. supports a compliance study instead of withholding.

Senator BYRD. Yes. I think it is well that you corrected that, because the Chair was under the impression that you could live with it.

Mr. DUNVILLE. Yes.

Mr. OFFEN. Mr. Chairman, the Dole bill requires that a contract be entered into between independent contractors and the companies with which they deal which specifically spells out their tax obligations. This is a new requirement.

In addition, we believe that the 1099 penalties for failure to file these information returns should be increased, so there is a deterrent factor there that does not presently exist.

I believe Treasury has also suggested that proposal.

Dr. Carlson has indicated that perhaps the 1099 should be required to be attached to the 1040 return and the 1040 return should probably be simplified in some way and identified, especially identifying independent contractors.

In addition, we think that it is very negligent on the part of the Service in their study to fail to find out whether or not the filings of 1099 forms increases compliance. They had all the data available to them. They could have found that out in their study; they neglected to do so.

Now they are coming in with a withholding proposal, when they do not have the information available, to see whether the information return and increased reporting can do the job instead of this more severe withholding approach.

Senator BYRD. Thank you.

Senator Dole?

Senator DOLE. We have a number of witnesses. The Associated General Contractors have suggested some modifications. I will study those modifications.

I am not certain other members of the panel have had an opportunity to look at the modifications suggested by the contractors. Any comments?

Mr. BODFISH. We agree, basically, with those modifications.

Senator DOLE. Are you aware of those modifications?

Mr. OFFEN. Yes, sir, Senator Dole.

We think that every industry can draft modifications to come in with specific exemptions. We can do it ourselves if that is the Senate's desire and the Congress's desire. The coalition that has been working on this bill with the Senate and House bill who have been leaders in the area such as yourself, Senator Dole, have tried not to open a Pandora's box through expansion of the independent contractor role past its traditional usage.

While we sympathize with the concerns of any individual industry, we had hoped that the bill would be in a form that would provide a "safe harbor" for almost all traditional users and hopefully legislative language might be inserted to take care of the general contractors rather than entertain specific industry exemptions to this basic bill.

Mr. THURM. On that point, your bill is very strict in its terms. The reasons it is strict is to eliminate any possible abuses. At the same time, because of its strictness, your bill recognizes that one set of tests may not be applicable to every possible industry and occupation affected by this issue, and that is why your bill does provide this important "safe harbor".

Any group that does not meet or follow your very strict tests will still have an opportunity to be treated under the common law as independent contractors.

For that reason, a modification may not be appropriate at this time.

Mr. LEHR. For the insurance industry, we think the bill is as it should be. I have not acquainted myself with the suggested changes, but incorporating the 20 common law tests into the act, if that is done, we would be back in the never-never land that we are in now. For 25 years our agents were, and we think they still are, independent contractors but the Internal Revenue Service does not

and we would be right back in litigation. We need a definitive statement. That is set forth in your bill.

Senator DOLE. I would like to think there can be a general agreement that does not come unglued because of any modifications. If some are reasonable and necessary, they should be adopted. Otherwise, I would be opposed them.

It would be helpful for the record to indicate whether members of the panel believe that the Treasury has addressed the fundamental problem. The fundamental problem, is the uncertainty in the common law.

I am not certain that Treasury addressed that. Instead they went off on a different tact altogether and frankly left the impression that there is a lot of dishonesty deceipt and tax evasion going on with the people that you represent.

Does anybody have any comment on that?

Mr. OFFEN. Yes, sir. We do. We specifically object to the rhetoric that has been used, not in discussions, in terms of your legislation, the legislation pending before this subcommittee, but the underground economy that links prostitutes, professional gamblers, and racketeers with the independent contractor problem and tries to tie that as part and parcel of the whole big problem.

We certainly object to that type of rhetoric, and feel that 4 million people in our industry who are honest Americans—really, your friends, neighbors, and the people around the corner, as well as your relatives—because our industry is basically a part-time, supplemental industry. We strongly object to the statements that have been implied in terms of dishonesty and conscious tax evasion.

Senator DOLE. I may submit some other questions, Mr. Chairman. I know we have a lot of witnesses.

Mr. Bodfish?

Mr. BODFISH. I would like to clarify what I said about the contractors. The Tax Executives Institute which supports only minor modifications in your bill, which I think you are aware of, we would have to study in its entirety the contractors proposals.

Senator DOLE. I do not have any quarrel with the contractors. I do not want to get into a modification game here. We would be around the rest of the year. I would like to mark something up and pass it. I know Treasury would like to have us do that.

Mr. CRANE. Senator, as an independent contractor, I would like to say that I certainly appreciate your five points. We need to be identified, the company needs to know who we are, we need to know who we are, and the Government needs to know who we are.

I would hate to see any tampering with those five points.

Senator DOLE. Maybe we could take care of it in the report language, or something.

Thank you.

Senator BYRD. Thank you, Senator Dole.

Senator Talmadge?

Senator TALMADGE. I have no questions, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

There will be a second panel.

Mr. BODFISH. Mr. Chairman?

Senator BYRD. Yes.

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Mr. BODFISH. The Tax Executives Institute has prepared a very comprehensive statement and, at your pleasure, we would request that it be made a part of the record.

Senator BYRD. That will be made a part of the record.

[The prepared statements of the preceding panels follow:]

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STATEMENT OF DR. JACK CARLSON

EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST

AND GIL THURM, VICE PRESIDENT AND LEGISLATIVE COUNSEL, GOVERNMENT AFFAIRS

ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

ON S. 736

REGARDING THE TAX TREATMENT OF INDEPENDENT CONTRACTORS

BEFORE THE SENATE FINANCE SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

SEPTEMBER 17, 1979

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,780 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 726,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry. Principal officers are: Donald I. Hovde, President, Madison, Wisconsin; Ralph Pritchard, President-Elect, Oak Brook, Illinois; and Jack Carlson, Executive Vice President. Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington office is located at 925 15th Street, N.W., Washington, D.C. 20005. Telephone 202/637-6800.

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SYNOPSIS OF THE STATEMENT OF
DR. JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST
AND GIL THURM, VICE PRESIDENT AND LEGISLATIVE COUNSEL,
GOVERNMENT AFFAIRS, ON BEHALF OF THE
NATIONAL ASSOCIATION OF REALTORS®
ON S. 736
REGARDING THE TAX TREATMENT OF INDEPENDENT CONTRACTORS
BEFORE THE SEANTE FINANCE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
SEPTEMBER 17, 1979

We are pleased to testify today in support of the Employment Tax Act of 1979, S. 736, introduced by Senators Dole, DeConcini and Matsunaga. We urge that the Committee favorably report this bill. This legislation would accomplish the following:

- Provide reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or an independent contractor.
- Provide a "safe harbor" by giving certainty as to tax status to independent contractors who are able to satisfy the five strict requirements outlined in the bill. However, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five "safe harbor" provisions. This "safe harbor" approach is important because it would be virtually impossible to design one specific legislative proposal to clearly meet the needs of all the numerous occupations and industries affected by the issue.
- Offer a measure of certainty to those industries, such as the real estate industry, where the IRS's attempt to reclassify individuals as employees has disrupted business relationships.

The interim relief from unjustified IRS harassment activity on this issue provided by Section 530 of the Revenue Act of 1978 will expire at the end of this year. For this reason, it is important to focus now on reasonable long-term legislative standards. If no such legislative solution can be enacted prior to year-end, we urge that the interim relief provision be extended.

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In contrast to this legislation is a withholding tax proposal presented by the Treasury Department. We heartily oppose this proposal, which would:

- Institute a withholding system whereby persons making payments to independent contractors would be requirea to withhold 10% tax on such payments.

- Retain the existing common law test for classifying an individual either as an employee or independent contractor without clarifying the standards to be used in making such a determination.

The Treasury proposal does not focus on the need to clarify the status of individuals as employees or independent contractors and ignores the fact that a withholding system would be far more costly to the real estate industry than any increase in tax revenues that could be derived as a result of withholding. According to figures released by the IRS, compliance is better than 96% among independent contractor salespeople in the real estate industry. Consequently, a withholding system is neither warranted nor necessary. If some compliance problem is found to exist, that problem can be addressed through administrative measures, such as increased information reporting requirements or penalties.

SUMMARY

Mr. Chairman and Members of the Committee:

My name is Jack Carlson, Exeuctive Vice President and Chief Economist, and I am accompanied by Gil Thurm, Vice President and Legislative Counsel, Government Affairs of the NATIONAL ASSOCIATION OF REALTORS®.

This Association, with over 726,000 members, is the largest trade association in the United States. We are concerned with all facets of the real estate industry -- residential, commercial, industrial and farm real estate.

We are pleased to testify today in support of the Employment Tax Act of 1979, S. 736, introduced by Senators Dole, DeConcini and Matsunaga. We urge that the Committee favorably report this bill.

Over the last several years, the IRS has misapplied the long-standing common law test to the point that it was attempting to coerce independent contractors in the real estate industry into employee status. That is, the IRS was trying to remove the freedom of choice of business relationships. We thank the members of the Committee and Congress in general for providing the needed interim relief from unjustified IRS harassment activity. This important relief provided by Section 530 of the Revenue Act of 1978 will expire at the end of this year. That is why it is important to focus now on reasonable legislative standards for next and future years.

The NATIONAL ASSOCIATION OF REALTORS® supports S. 736 for providing reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or independent contractor. The bill provides a "safe harbor" by giving

certainty as to tax status to independent contractors who are able to meet the five strict requirements contained in the bill. At the same time, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five "safe harbor" provisions.

The five requirements for safe harbor treatment in the bill are very strict, and should be strict to prevent workers who should obviously be classified as employees from inadvertently being reclassified as independent contractors. The bill was not designed or intended to allow "massive switchovers" and any objections on this point can be addressed through an "anti-switch" amendment if this objection proves to be a legitimate concern.

The Treasury Department proposal concerning the independent contractor issue does not focus on the need to clarify the status of workers as employees or independent entrepreneurs. Rather, the proposal of the Treasury Department concentrated on the initiation of a new 10% withholding system for independent contractors. The basis for this proposal is an IRS tax compliance study purportedly showing that a large percentage of independent contractors apparently do not pay their fair share of taxes. That IRS study, however, is of dubious validity for a variety of reasons we will set forth. Even though that study places the real estate industry among the highest category of tax compliance, we will illustrate that our compliance is even better than indicated. Accordingly, it is unwise, excessively costly, unnecessary, and a restriction of the freedom of choice to consider a new, burdensome and complex withholding scheme on the basis of an invalid study.

A limited amount of the tax return information on which the IRS study was based was made available to the public on July 5

pursuant to the Freedom of Information Act. After a review of even this limited data, we believe the study to be seriously deficient because of problems associated with sample selection, sample size and other methodology used in the study. Nevertheless, even according to the figures presented in the study, real estate salespeople have a compliance rate in excess of 96%. This compliance rate is much higher **than** that of the average taxpayer.

Given this high degree of compliance by the independent contractors in the real estate industry, we do not see how compliance could significantly improve if a withholding system were initiated. Even if some compliance problem were proven to exist, it would be premature to propose a new withholding system when simple and available administrative remedies have not been utilized to address the problem.

Let us make no mistake that a withholding system would be costly and burdensome. Many real estate brokers do not have any employees and therefore do not use any withholding system at present. For these small businesspeople, a withholding system would impose a new, unfamiliar and costly burden. A conservative estimate of the cost to each broker to implement and maintain such a withholding system is $500 per year. When we take into account the more than 200,000 real estate brokers who use independent contractors, which is 90% of all brokers, the total cost of withholding in the real estate industry alone is $100 million per year, $1 billion over a ten year period. Ultimately, this additional cost must be passed onto homeowners and other property owners and translates into an additional cost of $25 for each home purchased and $150 additional for the average household members during their lifetime.

The additional cost of $500 must be compared with the maximum possible increase of taxable income of $187 per real estate company according to the IRS study, which would require 100% aboslute compliance. So, we have the federal government requiring people to spend $500 so that the IRS under perfect conditions could collect $187. And, since the $500 is a deductible business expense, and many REALTORS® may be paying a marginal tax rate of 38% or higher, the Treasury could realize less net tax revenues from the real estate industry if a withholding system is initiated, even under perfect conditions.

In the most likely case, the IRS must expect less taxes from their proposed withholding system. Realistically, 1% or possibly 2% higher compliance is the best that can be expected. Even this amount would place compliance of real estate salespeople at above 97% to 98%, above most sectors of the U.S. economy. At this higher compliance level, an average of $50 more in taxes may be collected but only by imposing a withholding cost and burden of at least $500 and loss of freedom of choice. Thus, the IRS would require $10 to be spent by every broker for every $1 in additional tax receipts.

In the case of your home state of Virginia, Mr. Chairman, as shown on Table 6, the average real estate business would be forced to spend $495 more each year to satisfy IRS's proposed reporting system which would ultimately increase the cost of funding homes in Virginia by $24.75 or a total of $2,500,000 higher cost for the homes expected to be purchased during 1980 and each year thereafter in Virginia. For this huge increase in cost,the IRS may collect $47 from each real estate business or $2.50 per home or $230,000 from the entire state. Thus, REALTORS® and homeowners in Virginia would have to pay $10 for each additional one dollar col-

lected by the IRS.

In summary, the IRS compliance study is not an accurate indicator of tax compliance by independent contractors in the real estate industry and, even if one accepts the figures in the study, the compliance rates shown for these independent contractors are already extremely high. As a result, a withholding system is simply not warranted or necessary or desirable. However, we do need reasonable legislative standards for determining independent contractor status to substitute for arbitrary determinations by the IRS. Accordingly, we urge the Committee to help resolve this problem and favorably report S. 736 to the full Senate.

BACKGROUND

For over 40 years, the central controversy in the employment area has been the question of whether particular workers or classes of workers should be treated as employees or as self-employed independent contractors. The distinction is important under existing law because employees and their employers are subject to tax under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) (Sections 3101 and 3301 of the Internal Revenue Code), whereas independent contractors are subject to tax on self-employment income (SECA) imposed by Section 1401 of the Code. Also, compensation paid to employees is subject to income tax withholding under Section 3402 of the Code, whereas independent contractors make quarterly income tax payments on their own behalf. Further, self-employed persons can establish Keogh retirement plans, whereas employees may not (although they may be able to establish Individual Retirement Accounts). Thus, reclassification of an independent contractor as an employee can cause a retirement plan to become taxable in the current year.

It is also important to note that income and Social Security taxes are withheld from an employee based on his gross compensation, whereas an independent contractor pays these taxes based on his net earnings after expenses. The distinction is very important to many independent contractors, such as real estate salespeople, who incur significant expenses in the pursuit of their livelihood. Reclassifying real estate salespeople as employees and thereby basing these taxes on gross earnings causes problems regarding overwithholding of income taxes. The problem of overwithholding of income taxes arises, for example, in the case of a real estate salesperson with significant but

fluctuating business expenses. While a taxpayer may claim additional personal exemptions on his employee withholding statement to reduce the amount withheld from his gross income, it may be difficult, if not impossible, for a real estate salesperson to estimate the amount of his future business expenses and, thus, the proper number of additional exemptions to claim.

One of the major reasons for the attempt by the Internal Revenue Service to reclassify independent contractors as employees is to make its own administrative functions easier. Yet, the IRS is trying to make sweeping substantive changes in the law to ease these administrative duties. A reclassification of independent contractors as employees would produce little if any additional revenue. Revenue is not greatly increased because an independent contractor pays, on his own behalf, income and Social Security taxes corresponding to those withheld and paid by an employer on behalf of his employees. (There may be some increase because of the difference between FICA and SECA taxes). Revenue may, in fact, be decreased because reclassification as an employee may cost the marginal worker his livelihood due to increased tax, administrative, and bookkeeping costs to the alleged employer.

The Treasury Department has now claimed, based on an Internal Revenue Service compliance study of dubious validity, that the present lack of withholding of income taxes on payments to independent contractors causes underreporting of income on tax returns. Yet, according to the IRS's own data, at least 96% of the compensation received by independent contractors in the real estate industry is reported on tax returns. This is higher than the average level of compliance found in the American economy.

Further, the General Accounting Office (GAO), in its report to the Joint Committee on Taxation regarding the tax treatment of employees and self-employed persons (dated November 21, 1977), stated that "those taxpayers involved in employee self-employed redeterminations had generally paid their income and Social Security taxes." GAO Report at 24. Moreover, GAO pointed out that the IRS failed to consider other possible administrative approaches to the problem of underreporting.

Nevertheless, in order to prevent the alleged underreporting of income by independent contractors, the Treasury Department has proposed the initiation of a burdensome and ill-considered withholding scheme under which all real estate brokers would be required to withhold tax on commissions paid to independent contractors. At the same time, however, the Treasury Department would do nothing to provide necessary and desirable clarification to the tax status of independent contractors in the real estate industry. Clarification of tax status has become necessary only over the last few years, and only because of the misapplication of the long established common law test by the IRS.

The history of the tax treatment of real estate salespeople as employees or independent contractors under the common laws test goes back many years. In 1938, the IRS issued a Social Security Tax ruling, S.S.T. 346, 1938-2 C.B. 300, which concluded that a typical real estate broker did not retain sufficient right to control the salespeople to establish the relationship of employer and employee. Five years later, the IRS concluded that S.S.T. 346 was erroneous and published Mimeograph 5504, 1943 C.B. 1066, holding that real estate salespeople in general should be treated as employees rather than independent contractors.

The courts, however, refused to accept the new position of the Service that real estate salespeople should be treated as employees rather than independent contractors. The courts held, first in Broderick v. Squire, 163 F. 2d 980 (9th Cir. 1947), and then in the leading case of Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan, 179 F. 2d 882 (8th Cir. 1950), that real estate salespeople should be treated as independent contractors under the authority of the decision of the U.S. Supreme Court in Harrison v. Grey Van Lines, 331 U.S. 704 (1947). The result in Dimmitt was accepted by the Service in Mimeograph 6566, 1951-1 C.B. 108, which revoked Mimeograph 5504 and stated that real estate salespeople would not be treated as employees where the facts are substantially similar to those of Mimeograph 5504 or the Dimmitt case.

For a quarter of a century after the publication of Mimeograph 6566 in 1951, it remained in effect as the official position of the IRS. Then, as a result of the misapplication of the common law test of control and for reasons of administrative convenience, the IRS suddenly reversed this position and took the view that real estate salespeople are employees and not independent contractors. Revenue Ruling 76-136, 1976-1 C.B. 312, and Revenue Ruling 76-137, 1976-1 C.B. 313. These Revenue Rulings were subsequently revoked by Revenue Ruling 78-365, 1978-2 C.B. 254, as a result of Congressional interest in connection with the Revenue Act of 1978.

The IRS misapplied the common law test of control because it has apparently adopted the view that the existence of one "controlling factor" in a business relationship requires a worker to be classified as an employee, contrary to the established rule

that no single factor is controlling on the classification question. See Treasury Regulation Section 31.3121(d)-1(c).

The Treasury Department, through the IRS, took this approach because it apparently believes that it is more convenient to collect taxes under a withholding scheme than to perform its true function of enforcing the laws enacted by Congress. In order to impose this withholding burden, it was necessary to reclassify real estate salespeople as employees rather than independent contractors.

As a result of this action, the common law test of control, which has served us well over the course of many years, has been distorted and misapplied by the whim of a Federal regulatory agency for purposes of its own administrative convenience. The NATIONAL ASSOCIATION OF REALTORS® urges this Committee to give serious consideration to the enactment of reasonable legislative standards under which real estate salespeople and other independent contractors can be certain as to their status for employment tax purposes. The standards proposed in the Employment Tax Act of 1979, S. 736, discussed below, are reasonable and will give certainty to brokers and to real estate salespeople as to their tax status.

THE EMPLOYMENT TAX ACT OF 1979

The Employment Tax Act of 1979, S. 736, introduced by Senators Dole, DeConcini and Matsunaga and a companion bill, H.R. 3245, introduced by Congressman Richard A. Gephardt and some 150 bipartisan members in the House of Representatives, would provide a set of five requirements that, if satisfied, would result in a worker being treated as an independent contractor. All five of the requirements must be met before a worker will be treated as an independent contractor under the Act. If the worker is not able to satisfy all five

requirements, his status will be determined under the common law test.

The five requirements listed in the Act for "safe harbor" treatment as an independent contractor are the following:

(1) The worker must control the aggregate number of hours actually worked and substantially all the scheduling of the hours worked.

(2) The worker does not have a principal place of business or, if he does, it is not provided by the person for whom services are performed or, if it is so provided, the worker pays an arm's length rent therefor. For purposes of this test, a worker does not have a principal place of business if he does not perform substantially all his services at a single fixed location.

(3) The worker has a substantial investment in assets used in connection with the performance of his services or risks income fluctuations with respect to his services.

(4) The services of the independent contractor must be performed pursuant to a written contract that spells out the individual's status as an independent contractor and the consequences and responsibilities of such status.

(5) The person or company for whom the worker performs the services must file all required information returns (such as Form 1099).

Mr. Chairman, a reasonable interpretation of S. 736 would give taxpayers certainty in this area while at the same time addressing the concerns of the Treasury Department and the Social Security Administration.

Control of Hours Worked

The Act would require that the worker control his working hours in order to qualify for the "safe harbor." This test will be satisfied only if the worker has the right to control the total number of hours worked. Control of working hours is one of the critical factors in the common law test for classifying workers as either employees or independent contractors.

We should emphasize that the fact that an independent contractor performs services for only one person or company during the year has no bearing on this test. For example, real estate salespeople under state law in all 50 states may perform services for only one real estate broker at a time. The salespeople are not allowed under state law to simultaneously perform services for two or more brokers. This requirement does not affect the control of hours, and real estate salespeople could meet the test as long as they had the right to control the aggregate number of hours worked and substantially all of the scheduling of these hours.

Place of Business

This requirement of the Act takes into account the fact that, under the common law test, an independent contractor provides his own principal place of business or may have no one principal place of business. This requirement in the Act also takes into account, however, the realities of doing business in a modern society. Thus, the Act would allow the person for whom services are performed to provide the independent contractor with his principal place of business, but only if the worker pays rent therefor. This rent may be either a reasonable fixed amount paid by the independent contractor or a mutually agreed upon division of fees or commissions.

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The place of business test in the Act also recognizes that many individuals, real estate salespeople among them, simply should not be treated as having a principal place of business. Real estate salespeople do not perform their services at a single fixed location even though the brokers for whom they perform these services often provide desks for their use. Since real estate salespeople move from home to home and customer to customer, the Act would correctly treat them as having no principal place of business for purposes of this test.

Investment or Income Fluctuation

The Act would codify the common law provision that an independent contractor's income level is not fixed or guaranteed. A real estate salesperson may make sales presentations over a period of time and incur significant expenses and yet, if no sale was made, he would derive no income for his efforts. In fact, he would incur a loss.

It is the risk of income fluctuation that is the crux of this test. Actual income fluctuation may arise from a variety of factors having to do with the salesperson's skill and degree of effort. However, as long as the salesperson exposes himself to the risk that, despite all his efforts, he may generate no sales and therefore no income, this test would be satisfied.

This test may also be satisfied if the worker has a substantial investment in the assets used in connection with the services performed. A real estate salesperson, for example, who buys an automobile for business use -- to drive customers or clients to see different properties, for example -- would satisfy this portion of the test.

Written Contract and Filing of Required Returns

The final two "safe harbor" provisions in the Act would require the worker and the person for whom the services are to be performed to enter into a written contract, prior to the performance of the services, clearly indicating that the worker is an independent contractor and his tax responsibilities as a result of that status. Further, all information returns must be filed by the person for whom services are performed.

These requirements are intended to ensure that workers are aware of the tax responsibilities arising from independent contractor status and are provided with all the information necessary to meet these responsibilities. These two requirements also ensure that the IRS has all the information necessary to monitor the tax collection process.

COMMENTS ON S. 736

The five requirements set forth in the Act are very strict. The NATIONAL ASSOCIATION OF REALTORS® believes that the requirements should be strict in order to prevent workers who should obviously be classified as employees from inadvertently being reclassified as independent contractors.

The Employer Tax Act of 1979, S. 736 was not designed or intended to "reclassify" anyone as an independent contractor and we strongly disagree with the Treasury Department that many workers who are presently considered employees would become independent contractors under the Act. The Act was, however, designed and intended to establish rules and provide certainty in those industries where the IRS's reclassification program has disrupted business relationships and threatened the very existence of

the independent businessperson. The only individuals who may be reclassified as independent contractors under the Act are those individuals who, as a result of the coercion and heavy-handedness of the IRS reclassification program, were forced into employee status and are returning to their rightful place among the ranks of independent contractors.

It is unclear why the Treasury Department has seen fit to raise the argument that, solely as a result of this act, individuals would suddenly deem it essential to refer to themselves as independent contractors. S. 736 does nothing more than codify the long-established independent contractor standards of the common law. Since we have not experienced massive switchovers under these long-established standards over a course of so many years, we do not believe we will have massive switchovers as a result of this Act. In fact, given the strictness of the five requirements listed in the Act, massive switchovers are simply not possible.

THE TREASURY DEPARTMENT PROPOSAL

The proposal advanced by the Treasury Department before the House Ways and Means Subcommittee on Select Revenue Measures on June 20 would retain the existing common law test for classifying a worker either as an employee or an independent contractor and impose a 10 percent withholding tax system on the gross income of workers determined to be independent contractors, without taking into account the expenses incurred by these people in the performance of their services. The basis for this proposal is a compliance study conducted by the IRS purportedly showing that 47% of independent contractors surveyed did not report any of their income tax returns. The non-compliance rate in the real estate industry was reported to be 20%.

The IRS Compliance Study

Mr. Chairman, a limited amount of the tax return information on which the IRS study was based was made available to the public on July 5. After reviewing the limited available data, we are pleased to report that, according to the figures in the study itself, the independent contractor salespeople in the real estate industry have a compliance rate of at least 96%. This is in marked contrast to the 80% rate alleged by the Treasury Department in its testimony. There are a number of reasons for this discrepancy in compliance rates, and we would like to point out some of these reasons, which we have shared with the Treasury Department (Attachments 1 and 2).

As members of this Committee are aware, a valid statistical study of any kind, including the IRS study, must begin with a defined universe of people, things, quantities, measurements, and so on that is to be studied. Once the universe is defined, care must be taken to select a representative, random sample from the universe so that whatever findings are made may be applied generally to that universe. Based on our review of the information on which the IRS study was based, it appears clear that the universe of individuals to be studied was not representative or random and thus was biased. Consequently, while the results provided by the Treasury Department in its testimony illustrated a high level of compliance in the real estate industry, the actual compliance level is still higher.

The focus of S. 736 is the tax status of independent contractors. The tax compliance of workers who are employees is therefore not in question. Yet, the IRS study included individuals whose compliance was being studied. In fact, fully one-fourth

of all workers whose tax compliance was measured by the IRS may be employees, including clerical workers, skilled and unskilled laborers and others. Salespeople are the primary independent contractors in the real estate industry and this group comprised only 152 of the 213 individuals, 71%, audited in the study. Even some salespeople, moreover, qualify as, and are treated as, employees by real estate companies.

It is clear from the foregoing that the universe of independent contractors in the real estate industry was not clearly defined for purposes of the study. We certainly make no claim that all clerical workers in the real estate industry are independent contractors, and the inclusion of this group as well as other groups of workers who may be employees is a fundamental error of the study.

The IRS study is also seriously deficient in sample selection. As previously mentioned, only 152 of the 213 workers in the real estate industry who were audited as part of the study are salespeople, the primary type of worker in our industry who is considered an independent contractor. There are approximately 1.1 million independent contractor salespeople in the real estate industry. 152 people is simply much too small a sample from which to draw any inference concerning such a large group. In fact, elementary statistics would require a sample size of at least 600 individuals in order to obtain representative findings concerning 1.1 million individuals with even 95% accuracy.

The relative size of the sample notwithstanding, a review of part of the methodology of the IRS study made available also reveals that the 213 workers selected for audit were not chosen randomly, which is, of course, required for accurate and unbiased results. A review of the methodology clearly points out the fact

a significant number of the individuals selected were already suspected of being employees by the IRS and were already suspected of having compliance problems when the study was initiated. There can be no doubt that the workers in the study are not representative of the independent contractors in the real estate industry.

The study basically divides these suspect workers into four groups: "initial selection", "previously filed", "delinquent return secured", and "refusal to file". The Treasury Department has not provided any explanation of the meaning of these terms as to the study as requested under the Freedom of Information Act in early July. Consequently, we have had to rely solely on the limited background data IRS has supplied for an indication of their meaning.

Salespeople in the initial selection and previously filed categories, who comprise 144 of the 152 independent contractors in the study, are the only independent contractors in the real estate industry who may have been selected randomly, laying aside for the moment that these people were already suspected of being employees by the IRS. The selection for study of anyone who files a delinquent return or who refuses to file a return for whatever reason will always give rise to inappropriate results and will always lower the average compliance rate of those individuals who were selected randomly.

Let us dwell for a moment on the delinquent filers and those who refuse to file. By definition, a person who files a delinquent return is merely a person who files a return later than the due date. But he does file and he does presumably report his income on this late return. The study treats this person as never having filed, however, and attributes to him a compliance rate of zero. And those who refuse to file may have a valid reason for doing

so, such as not having earned enough income so as to be liable for any tax, and the study also gives them a zero compliance rate. These errors in the study make the Treasury findings particularly misleading and we feel it is only fair to concentrate only on those individuals in the initial selection and previously filed categories in our further discussion.

We have shown that the IRS study is deficient because it did not accurately define the universe of independent contractors, the sample size was much too small, and the sample was not randomly selected. Nevertheless, despite these deficiencies, let us look at the compliance figures for real estate salespeople in the portion of the sample that may have been randomly selected in an unbiased and fair way. The compliance figures are presented in tabular form in the appendix to our testimony.

Tables 1 and 2 show the percentage of individuals in the real estate industry who reported none or only some of their compensation on their income tax returns. Table 1 deals only with salespeople, whereas Table 2 covers all of the workers audited in the real estate industry. Table 1 also shows the figures for salespeople by type of return. In Table 1, the figures for the initial selection and previously filed categories show that the zero compliance rate for salespeople in these categories is 1.5% and 0%, respectively, a very high compliance rate according to IRS. By contrast, when we look at the figures for all workers in the real estate industry in Table 2, including the individuals who appear to be employees, the [illegible] compliance rate rises to 20.2%.

Tables 3 and 4 pre[illegible] s showing the percentage of compensation received b[illegible] ls in the real estate industry that was actually repor[illegible] returns. Table 3 presents the figures for salespeople, [illegible] wn by the four types of returns

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audited in the study. Table 4 reports this information for all workers in the industry, but not broken down by type of return. Looking at the figures, we see that Table 3 shows that, in the initial selection and previously filed categories 96.2% and 100% of the compensation paid salespeople was reported, a very high compliance rate compared to the figures in the IRS study. When we look at the figures for all workers in Table 4, the percentage of compensation reported is 89.5%

The figures shown in Tables 1 and 3 strongly support our view that the tax compliance rates for independent contractors in the real estate industry are extremely high. We ask you to look at these figures and compare them with the inaccurate figures emphasized by the Treasury Department in its testimony before the House Ways and Means Subcommittee on Select Revenue Measures on June 20. We ask you to keep in mind too that our figures were also drawn from the IRS's own study. Finally, please bear in mind that if IRS had provided more complete data, the findings would have been more favorable to independent contractors and more critical of the IRS study.

We have demonstrated that the IRS compliance study, which was the foundation of the Treasury Department's proposal to initiate a withholding system for independent contractors, is biased, inaccurate and misleading and unfairly reflects upon the commendable compliance rate of the independent contractors in the real estate industry and that the compliance rate of these independent contractors, even according to the IRS's own figures, which were badly designed so as to understate compliance, exceeds 96%.

Given such a high rate of compliance, the NATIONAL ASSOCIATION OF REALTORS® does not believe that the initiation of a burden-

some and costly withholding system for independent contractors is either warranted or necessary. The proposal to initiate a withholding system appears to be an overreaction to an alleged problem of noncompliance, even if we were to assume that there is a problem. It is premature to propose a withholding system, with the cost and administrative burden involved, when simple and available administrative remedies have not been utilized.

What are these administrative remedies? One immediately comes to mind. At the present time any person making payments to an independent contractor in the course of trade or business must file an information return, a Form 1099, with the IRS. There is no requirement, however, that a copy of this Form 1099 be given to the independent contractor and there is certainly no requirement that the independent contractor, even if he is voluntarily given a copy of the Form 1099, do anything with it. It stands to reason that compliance would be increased if the person for whom services are performed is required to furnish a copy of the Form 1099 to the independent contractor. In this way, the independent contractor would know the exact amount of sales or gross commission income he should report on his income tax return and would also be made aware that the information on the Form 1099 was being sent to the IRS. Other administrative solutions are available as well, none of which would give rise to the costs and burdens involved with a withholding system.

Mr. Chairman, there can be no doubt that a withholding system would involve heavy and substantial administrative burdens. Many real estate brokers already withhold taxes from employees, to be sure. However, many others do not have any employees at all, not even a secretary or receptionist, and it is unfair to force

them to hire an accountant or bookkeeper and incur additional expenses for paperwork, office space, overhead, and so on, when other, simpler solutions to the alleged problem of compliance by independent contractors are available.

The IRS compliance study states that the average real estate broker has 2.6 workers, approximately 2.0 of whom are salespeople - independent contractors. The study further states that if all independent contractor salespeople in the real estate industry were in 100% compliance, which is of course a higher rate of compliance than attained by employees who are subject to withholding, the commissions reported would increase by $267 and taxes collected would increase by $93.50, per independent contractor. In the average real estate brokerage, with two independent contractors, a withholding system would at best increase tax revenues by $187. The cost of withholding compared with additional anticipated tax revenues arising from withholding is presented in Table 5.

To obtain this hypothetically perfect record of compliance the broker would have to file reports each month instead of once a year. Some brokers now estimate that each annual report they prepare and file costs $40.00. The additional requirement to file the report each month could be expected to cost nearly as much as the annual report and, when considered over 11 additional months, would equal a minimum of $500 per year, perhaps higher. This, of course, is the system to collect the data, verify the data for compliance with federal regulations, and actually file the report with the federal government. This $500 additional cost required by the Internal Revenue Service's proposed reporting system must be compared with the maximum possible increase of taxable income of $187. So, we have the bad situation of the federal

government requiring people to spend $500 so that the IRS can get $187.

Inasmuch as there are approximately 200,000 real estate brokers throughout the country whose salespeople are presently independent contractors, a withholding system would cost the real estate industry a minimum of $100 million per year, $1 billion over a ten year period. The additional cost would be borne by purchasers and sellers of homes and could increase the cost of every home sold by $25. This would add even more to the cost of home ownership, which has been escalating very rapidly each year. An illustration of the effect of this $25 per home increase in the fifty states is provided in Table 6. This increased cost would fall on those people least able to handle additonal cost; that is, people purchasing their first home, who are usually young families, and those older people looking to sell their existing home for a smaller retirement home.

Realistically, the IRS could expect only 1% higher overall compliance, which would mean identifying only $67 more taxable income on the average and additional tax payments of $23 more on the average. Inasmuch as the paperwork and reporting cost would still be the same, we have the very bad situation of the IRS requiring $100 of increased paperwork and reporting requirements for each $10 that they receive in additional tax receipts. It is these kinds of costly federal regulations that are causing people to feel harassed by their government.

The imposition of such a costly and burdensome program as a withholding system for independent contractors is also inconsistent with the stated intention of President Carter and the Commission on Federal Paperwork to reduce the burdens which reporting to the

federal government places on the American public. In his October 3, 1977 letter to the President in submitting the report of the Commission on Federal Paperwork, the Chairman of the Commission stated:

> Many people feel, and the Commission agrees, that a multi-billion dollar wall of paperwork has been erected between the Government and the people. Countless reporting and recordkeeping requirements and other heavy-handed investigation and monitoring schemes have been instituted based on what we view as a faulty premise that people will not obey laws and rules unless they are checked, monitored, and re-checked.
>
> This situation and this assumption must be reversed if we are to restore efficiency within Government and confidence in Government by the people and if we are to realize the potential for cooperative attainment of our goals as a Nation.

A withholding system for independent contractors is precisely the kind of multi-billion dollar wall of paperwork that the Commission was talking about.

We would also like to point out that the added cost of a withholding system would be borne not by large corporations but by the individual small businessperson who is at the heart of the real estate industry in this country. These brokers are not equipped with sophisticated equipment such as computers with which they can easily implement a withholding system for their salespeople. Nor do they have staff accountants or bookkeepers who will do the work related to withholding as part of their everyday routine. A new withholding system would place yet another unnecessary bureaucratic paperwork burden on the small businessperson.

The NATIONAL ASSOCIATION OF REALTORS® does not condone noncompliance by independent contractors. We believe that every person should pay his or her fair share of taxes. However, to the extent that administrative remedies are presently available to

address the compliance issue, we believe that these administrative remedies should be utilized before a new withholding system is even contemplated for independent contractors.

CONCLUSION

The NATIONAL ASSOCIATION OF REALTORS®, like members of this Committee, is committed to the principle that every individual should pay his rightful share of taxes. If certain individuals do not pay their taxes, it makes the cost of government higher for the rest of us.

Given the high level of compliance in the real estate industry, however, a withholding system for independent contractors is not necessary. What is necessary at this time is a measure of certainty in determining the classification of a worker as an employee or independent contractor. S. 736 would provide this certainty while at the same time maintaining the freedom to enter into a business relationship as an employee or independent contractor.

We appreciate this opportunity to present our views on this matter of urgent concern. We will be happy to try to answer any questions the Committee may have. Thank you.

APPENDIX*

TABLE 1

INCOME TAX COMPLIANCE RATES OF REAL ESTATE SALESPEOPLE

BY TYPE OF RETURN**

Selection Process of Returns for Real Estate Salespeople	Total Number of Returns	Percentage of Payees with: Full Compliance	Partial Compliance	Zero Compliance
All returns	152	88.8%	4.6%	6.6%
Initial Selection	129	93.3%	4.7%	1.6%
Previously Filed	15	93.3%	6.7%	.0%
Delinquent Returns Secured	5	.0%	.0%	100.0%
Refusal to File	3	.0%	.0%	100.0%

* All tables in the Appendix were prepared by Paul Maihan, Economics and Research Division, NATIONAL ASSOCIATION OF REALTORS®, and John G. Ams, Director of Tax Programs of the NATIONAL ASSOCIATION OF REALTORS®.

** Source: IRS Employee/Independent Contractor Compliance Study (June, 1979)

TABLE 2

INCOME TAX COMPLIANCE RATES IN REAL ESTATE BY OCCUPATION*

Occupation	Percent of Payees With: Full Compliance	Partial Compliance	Zero Compliance
Real Estate, Total	75.1%	4.7%	20.2%
Manager, Distribution	50.0	10.0	40.0
Skilled Labor	40.0	.0	60.0
Unskilled Labor-Casual	50.0	.0	50.0
Unskilled Labor-Noncasual	28.6	.0	71.4
Sales	88.8	4.6	6.6
Professional	60.0	.0	40.0
Clerical	28.6	14.3	57.1
Other	.0	.0	100.0

*Source: IRS Employee/Independent Contractor Compliance Study (June, 1979)

TABLE 3

PERCENT OF COMPENSATION RECEIVED THAT WAS REPORTED ON THE TAX RETURNS OF REAL ESTATE SALESPEOPLE, BY SELECTION PROCESS OF RETURNS*

Selection Process of Returns for Real Estate Salespeople	Total Number of Returns	Number Reporting Correctly	Total Wages		Percent of Compensation Reported
			As Reported	As Corrected	
All Returns	152	135	$1,141,500	$1,223,000	93.3%
Initial Selection	129	121	986,500	1,025,000	96.2
Previously Filled	15	14	154,500	154,500	100.0
Delinquent Returns Secured	5	0	0	24,500	.0
Refusal to File	3	0	0	19,000	.0

* Source: IRS Employee/Independent Contractor Compliance Study (June, 1979)

TABLE 4

PERCENT OF COMPENSATION RECEIVED THAT WAS REPORTED ON THE TAX RETURNS OF PEOPLE WORKING IN REAL ESTATE, BY OCCUPATION, FOR ALL TAX RETURNS *

Occupation	Number of Workers	All Returns Reported Wages	Corrected Wages	Percent
Real Estate, Total	213	$1,265,000	$1,413,500	89.5%
Manager, Distributor	20	86,000	109,000	78.9
Skilled Labor	5	16,000	22,500	71.1
Unskilled Labor-Casual	8	10,000	15,000	66.7
Unskilled Labor-Noncasual	14	2,000	15,500	12.9
Sales	152	1,141,500	1,223,000	93.3
Professional	5	1,500	10,500	14.3
Clerical	7	8,000	16,000	50.0
Other	2	0	2,000	.0

*Source: IRS Employee/Independent Contractor Compliance Study (June, 1979)

TABLE 5

ADDITIONAL ANTICIPATED TAX REVENUES UNDER A WITHHOLDING

SYSTEM COMPARED WITH THE COST OF SUCH A SYSTEM, BY

LEVEL OF COMPLIANCE

LEVEL OF COMPLIANCE	ANTICIPATED ADDITIONAL INCOME REPORTED	ANTICIPATED ADDITIONAL TAX REVENUES AT 35% 4/	COST OF WITHHOLDING 5/	EXCESS OF COST OVER ADDITIONAL TAX REVENUE	RATIO OF COST OF WITHHOLDING TO ADDITIONAL TAX REVENUES
100% 1/:					
ALL BROKERS	$106,800,000 2/	$37,380,000	$100,000,000	$62,620,000	3 : 1
PER BROKER	534 3/	187	500	313	3 : 1
97% 6/					
ALL BROKERS	$ 26,700,000	$ 9,345,000	$100,000,000	$90,655,000	10 : 1
PER BROKER	133	47	500	453	10 : 1

1/ It is assumed that the "total wages as corrected" figure for the individuals in the initial selection and previously filed categories in Table 3 represents 100% compliance.

2/ The IRS Employee/Independent Contractor Compliance Study (June, 1979) found that the average real estate broker utilized the services of two independent contractor salespeople. Further, the average additional income that should have been reported by the salespeople in the "initial selection" and "previously filed" categories in Table 3 is $267. There are approximately 200,000 brokers in the real estate industry. Consequently, this figure was obtained as follows: (average additional income) X (number of salespeople) X (number of brokers). Or, $267 X 2 X 200,000 = $106,800,000.

3/ This is the product of multiplying $267 X 2. See Note 2 above.

4/ The IRS study assumes a 35% tax rate on any additional income reported.

5/ Cost of withholding is estimated to be $500 per year to the average broker.

6/ The present compliance rate for independent contractor salespeople in the initial selection and previously filed categories in Table 3 is 96%. A 97% compliance rate is approximated by assuming that only 25% of the difference between total wages reported and total wages as corrected in Table 3 would be collected under a withholding system.

Table 6

INCREASED COST OF THE IRS PROPOSAL
FOR WITHHOLDING REQUIREMENTS PER YEAR ON REAL ESTATE BROKERS AND HOMEBUYERS

State	Additional Costs of Withholding			Expected Tax Receipts For Withholding to Increase Compliance from 96 Percent to 97 Percent			Expected Tax Receipts For Withholding to Increase Compliance from 96 Percent to 98 Percent		
	Each Business	Each Home Sold	Total*	Each Business	Each Home Sold	Total*	Each Business	Each Home Sold	Total*
United States	$ 500	$25.00	$100,000,000	$ 47	$ 2.50	$10,000,000	$ 94	$5.00	$19,000,000
Alabama	405	20.25	1,560,000	39	2.00	150,000	78	4.00	300,000
Alaska	690	34.50	310,000	65	3.50	30,000	130	7.00	60,000
Arizona	470	23.50	1,600,000	44	2.35	160,000	88	4.70	320,000
Arkansas	400	20.00	960,000	38	2.00	100,000	76	4.00	200,000
California	570	28.50	12,940,000	54	2.85	1,290,000	108	5.70	2,580,000
Colorado	515	25.75	1,670,000	48	2.60	170,000	96	5.20	340,000
Connecticut	580	29.00	1,280,000	55	2.90	130,000	110	5.80	260,000
Delaware	545	27.25	300,000	51	2.75	30,000	102	5.50	60,000
Florida	480	24.00	6,220,000	45	2.40	620,000	90	4.80	1,240,000
Georgia	425	21.25	2,400,000	40	2.10	240,000	80	4.20	480,000
Hawaii	540	27.00	320,000	51	2.70	30,000	102	5.40	60,000
Idaho	435	21.75	460,000	41	2.20	50,000	82	4.40	100,000
Illinois	550	27.50	5,360,000	52	2.80	550,000	104	5.60	1,100,000
Indiana	495	24.75	2,970,000	47	2.50	300,000	94	5.00	600,000
Iowa	510	25.50	1,580,000	48	2.55	160,000	96	5.10	320,000
Kansas	510	25.50	1,300,000	48	2.55	130,000	96	5.10	260,000
Kentucky	435	21.75	1,500,000	41	2.20	150,000	82	4.40	300,000
Louisiana	420	21.00	1,450,000	39	2.10	140,000	78	4.20	280,000
Maine	410	20.50	410,000	38	2.05	40,000	76	4.10	80,000
Maryland	540	27.00	1,650,000	51	2.70	160,000	102	5.40	320,000
Massachusetts	530	26.50	1,960,000	50	2.65	200,000	100	5.30	400,000
Michigan	540	27.00	5,700,000	51	2.70	570,000	102	5.40	1,140,000
Minnesota	530	26.50	2,100,000	50	2.65	210,000	100	5.30	420,000

*The figures for individual states do not sum to the U.S. totals due to rounding.

Table 6 Continued

State	Additional Costs of Withholding			Expected Tax Receipts For Withholding to Increase Compliance from 96 Percent to 97 Percent			Expected Tax Receipts For Withholding to Increase Compliance from 98 Percent to 98 Percent		
	Each Business	Each Home Sold	Total	Each Business	Each Home Sold	Total	Each Business	Each Home Sold	Total
Mississippi	$ 360	$18.00	$ 900,000	$ 34	$ 1.80	$ 90,000	$ 68	$3.60	$ 180,000
Missouri	470	23.50	2,630,000	44	2.35	260,000	88	4.70	520,000
Montana	420	21.00	340,000	39	2.10	30,000	78	4.20	60,000
Nebraska	485	24.25	750,000	46	2.40	70,000	94	4.80	140,000
Nevada	570	28.50	540,000	54	2.85	50,000	108	5.70	100,000
New Hampshire	465	23.25	400,000	44	2.30	40,000	88	4.60	80,000
New Jersey	570	28.50	3,140,000	54	2.85	310,000	108	5.70	620,000
New Mexico	420	21.00	550,000	39	2.10	50,000	78	4.20	100,000
New York	535	26.75	5,620,000	50	2.70	570,000	100	5.40	1,140,000
North Carolina	425	21.25	2,270,000	40	2.10	220,000	80	4.20	440,000
North Dakota	465	23.25	260,000	44	2.30	30,000	88	4.60	60,000
Ohio	505	25.25	5,300,000	47	2.50	530,000	94	5.00	1,060,000
Oklahoma	455	22.75	1,660,000	43	2.25	160,000	86	4.50	320,000
Oregon	495	24.75	1,530,000	47	2.50	160,000	94	5.00	320,000
Pennsylvania	505	25.25	4,290,000	47	2.50	430,000	94	5.00	860,000
Rhode Island	490	24.50	290,000	46	2.45	30,000	92	4.90	60,000
South Carolina	405	20.25	1,220,000	38	2.00	120,000	76	4.00	240,000
South Dakota	455	22.75	270,000	43	2.30	30,000	86	4.60	60,000
Tennessee	415	20.75	1,850,000	39	2.10	190,000	78	4.20	380,000
Texas	485	24.25	6,960,000	46	2.40	700,000	92	4.80	1,400,000
Utah	425	21.25	450,000	40	2.10	40,000	80	4.20	80,000
Vermont	415	20.75	210,000	39	2.10	20,000	78	4.20	40,000
Virginia	495	24.75	2,250,000	47	2.50	230,000	94	5.00	460,000
Washington	535	26.75	2,590,000	50	2.70	260,000	100	5.40	520,000
West Virginia	445	22.25	710,000	42	2.25	70,000	84	4.50	140,000
Wisconsin	510	25.50	1,990,000	48	2.55	200,000	96	5.10	400,000
Wyoming	545	27.25	250,000	51	2.75	20,000	102	5.50	40,000

ATTACHMENT I

NATIONAL ASSOCIATION OF REALTORS®

Executive Offices:
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☒ 925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637-6800

Jack Carlson
Executive Vice President

June 22, 1979

The Honorable W. Michael Blumenthal
Secretary of the Treasury
Washington, D.C. 20220

Dear Mike:

In your Department's testimony on the independent contractor issue before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on June 20, your representative claimed that 20 percent of all real estate people are in "zero compliance" in paying federal income taxes. The National Association of Realtors is distressed that your Department would make such a statement based solely on reviewing returns previously judged to appear so suspicious as to require IRS audit. The fact that you may have found possible non-compliance among suspicious returns can hardly be surprising. Indeed, only a 20 percent non-compliance rate under these circumstances raises serious question about the ability of the Department to identify irregular returns and/or the fact that even among suspicious returns independent real estate people practice a high level of compliance.

While impugning the integrity of real estate people in general, the Treasury Department's testimony, as reflected in Table 9, appears to reverse the charge and reveals that the predominant real estate worker, the real estate salesperson, is in 94% compliance, which places him well above the average of individuals in other industries.

By your own table, it is the clerical worker and unskilled laborer who may have compliance problems. But these people are <u>employees</u>, not independent contractors, and thus referral to them is irrelevant to the Treasury Department's issue that prompted testimony. It is wrong to use their record to blemish the commendable performance by independent contractors.

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The National Association of Realtors believes that the compliance study is unfair and misleading. Such testimony should not be the basis for placing independent contractors in more of a federal regulation straitjacket and requiring unfair tax withholding.

In order to consider improvements in tax policy we would greatly appreciate receiving information consistent with the Freedom of Information Act as to the sample and survey results before the Congress requests our testimony on this subject.

Sincerely,

Jack

Jack Carlson

cc: Members, House Ways and Means Committee

REALTOR®

Attachment II

NATIONAL ASSOCIATION OF REALTORS

Donald I. Hovde, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637-6800

July 13, 1979

Mr. Donald C. Lubick
Assistant Secretary of the Treasury
(Tax Policy)
Washington, D.C. 20220

Dear Mr. Lubick:

Thank you for your timely response to my letter of June 22 concerning the results of the IRS study of the tax compliance of independent contractors. While we appreciate your effort to explain some of the problems apparent in the study, our review of the limited background data on which the study was based reinforces our belief that the study is biased, misleading and yields inaccurate results. Some of the more obvious errors in the study are discussed below.

As you know, a valid statistical study of any kind, including the IRS study, must begin with a defined universe of people, things, quantities, measurements, and so on that is to be studied. Once the universe is defined, care must be taken to select a representative, random sample from the universe so that whatever findings are made may be applied generally to that universe. Based on our review of the information on which the IRS study was based, it appears clear that the universe of individuals to be studied was not representative or random and thus was biased. Consequently, while the results provided by your Department in its testimony illustrated a high level of compliance in the real estate industry, the actual compliance level is still higher.

Further, the tax compliance of workers who are employees is not in question at this time. Yet, the IRS study included individuals who may be classified as employees in the universe of individuals whose compliance was being studied. In fact, fully one-fourth of all the workers in the real estate industry whose tax compliance was measured by the IRS may be employees, including clerical workers, skilled and unskilled laborers and others. We cannot be certain as to the status of these individuals since the IRS data is incomplete on this matter. Salespeople are the primary independent contractors in the real estate industry, however, and this group comprised only 152 of the 213 individuals, 71%, audited in the study. Even some salespeople, moreover, qualify as, and are treated as, employees by real estate companies.

It is clear from the foregoing that the universe of independent contractors in the real estate industry was not clearly defined for purposes of the study. We certainly make no claim that all clerical workers in the real estate industry are independent contractors, and the inclusion of this group as well as other groups of workers who may be employees is a fundamental error of the study.

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The IRS study is also seriously deficient in sample selection. As previously mentioned, only 152 of the 213 workers in the real estate industry who were audited as part of the study are salespeople, the primary type of worker in our industry who is considered an independent contractor. There are approximately 1.1 million independent contractor salespeople in the real estate industry. 152 people is simply much too small a sample from which to draw any inference concerning such a large group. In fact, elementary statistics would require a sample size of at least 600 individuals in order to obtain representative findings concerning 1.1 million individuals with even 95% accuracy.

The relative size of the sample notwithstanding, a review of part of the methodology of the IRS study made available also reveals that the 213 workers selected for audit were not chosen randomly, which is, of course, required for accurate and unbiased results. A review of the methodology clearly points out the fact that a significant number of the individuals selected were already suspected of being employees by the IRS and/or were already suspected of having compliance problems when the study was initiated. There can be no doubt that the workers in the study are not representative of the independent contractors in the real estate industry.

The study basically divides these suspect workers into four groups: "initial selection", "previously filed", "delinquent returns secured" and "refusal to file." Your Department has not provided any explanation of the meaning of these terms as to the study and as requested under the Freedom of Information Act. Consequently, we have had to rely solely on the limited background data IRS has supplied for an indication of their meaning.

Salespeople in the initial selection and previously filed categories, who comprise 144 of the 152 independent contractors in the real estate industry who may have been selected randomly, are the only independent contractors in the real estate industry, laying aside for the moment that these people were already suspected of being employees by the IRS. The selection for study of anyone who files a delinquent return or who refuses to file a return for whatever reason will always give rise to inappropriate results and will always lower the average compliance rate of those individuals who were selected randomly.

Let us dwell for a moment, however, on the delinquent filers and those who refuse to file. By definition, a person who files a delinquent return is merely a person who files a return later than the due date. But he does file and he does presumable report his income on this late return. The study treats this person as never having filed, however, and attributes to him a compliance rate of zero. And those who refuse to file may have a valid reason for not doing so, such as not having earned enough income so as to be liable for any tax, and the study also gives them a zero compliance rate. These errors in the study make the findings in the study particularly misleading and we feel it is only fair to concentrate only on those individuals in the initial selection and previously filed categories in our further discussion.

According to the limited amount of data made available concerning the real estate salespeople audited as part of the study, the individuals in the initial selection and previously filed categories had a zero compliance rate of 1.6% and 0%, respectively. Moreover, these individuals reported 96.2% and 100%, respectively, of their compensation on their tax returns. By contrast, your testimony emphasized a zero compliance rate in the real estate industry of 20.2% and alleged that only 89.5% of compensation received was reported.

Given the high rate of compliance illustrated above, which is taken from the IRS's own figures, the NATIONAL ASSOCIATION OF REALTORS® continues to believe that there is no basis for unfair tax withholding.

We are hopeful that additional background data concerning the IRS study will be made available in the very near future. We are confident that as additional data is released, the compliance rate of independent contractors in the real estate industry will be proven to be even higher than reported in the study, and much higher than other occupational industry groupings.

Sincerely,

Jack Carlson

cc: W. Michael Blumenthal

STATEMENT

OF

THE DIRECT SELLING ASSOCIATION

BEFORE

The Subcommittee on Taxation and Debt Management

of the

Committee on Finance

United States Senate

September 17, 1979

ADDENDUM

AN ECONOMIC ANALYSIS OF INDEPENDENT CONTRACTORS
AND THE DIRECT SELLING INDUSTRY

Prepared for the
Direct Selling Association

by
Robert R. Nathan Associates, Inc.
Washington, D.C.
September 14, 1979

SUMMARY OF STATEMENT

The Direct Selling Association strongly supports S. 736 as a reasonable and judicious solution to the problem of unjustified IRS attacks on the independent contractor status of direct salespeople and others. DSA's support for the bill is based on its safe harbor approach, which provides certainty for taxpayers and the government without abandoning traditional common law standards.

DSA opposes the Administration's proposal for withholding on independent contractors. It is based on an unrepresentative IRS study, it is unreasonable, would cost direct selling companies more than $70 million per year to administer and would produce, even when based on IRS data, less than $30 million in tax revenues from direct salespeople. DSA believes any concerns with tax compliance can best be dealt with through the implementation of the provisions of S. 736.

DSA opposes any Administration proposal to increase the self-employment tax.

DSA supports efforts to eliminate IRS authority to make retroactive income and employment tax assessments.

TESTIMONY OF DIRECT SELLING ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

My name is Neil H. Offen. I am President of the Direct Selling Association (DSA). With me today are John C. Beyer, President of Robert R. Nathan Associates, Inc. (RRNA), and Arthur J. Rothkopf of the Washington law firm of Hogan & Hartson, who serves as tax counsel to the Association. We are grateful for this opportunity to discuss on behalf of DSA S. 736 relating to the tax treatment of independent contractors.

The Direct Selling Industry

The Direct Selling Association is a trade association representing 129 direct selling companies and another 100 firms that supply goods or services to direct selling companies. As you know, direct selling is a method of distribution through which products and services are primarily marketed directly to consumers in their homes. Companies within the industry market virtually every type of consumer product and service imaginable: household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, home improvement products and services, food, vitamins,

and so forth. Most companies within the industry are small. In 1975 average direct selling company revenues were between $2 million and $3 million. Only 10 companies had wholesale revenues exceeding $100 million. Total industry sales currently approximate $8 billion annually.

But more important than the characteristics of the direct selling companies are the characteristics of the individual entrepreneurs who do business with the companies. DSA has retained Robert R. Nathan Associates, Inc. to analyze the economic characteristics of the industry and these salespeople and to assess the impact of the various proposals on the economic vitality of the industry. Their statement, which I request be included with our full written statement in the record of today's hearings, describes in detail the economic profile of salespeople in the direct selling industry.

There are virtually no barriers or requirements for entry into direct selling. It is a field open to anyone. There are also no demands that direct salespeople spend a given number of hours or sell at any particular time. For those reasons, direct selling has wide appeal among women who have significant family responsibilities. They are wives, mothers and direct sellers.

The flexibility and simplicity of the industry also attracts substantial numbers of minorities, the handicapped, and the elderly. In any year, about four million people engage in direct selling in the United States, with at least two million active in the business at any given time. Eighty percent of direct salespeople are women. Further, during any year, 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority of these salespeople -- 89% -- work part-time and nearly two-thirds work less than ten hours per week.

For most direct salespeople, selling is not seen as a "job" but as an additional earning opportunity -- a way for many people with modest or fixed incomes to supplement their earnings and make ends meet. This conclusion is confirmed by the fact that median earnings of direct salespeople in 1975 were $27 per week. In that year, one half of direct salespeople earned less than $675 per year of gross income from direct selling, which does not take into account their expenses.

In most cases, this modest supplemental income is earned by families who, especially in today's economy, need it most. The median total income of direct sellers in 1976 was $13,840, and 27% of direct salespeople had a family income of less than $10,000.

Many direct salespeople sell intermittently and for different companies, establishing short-term specific earning goals and then terminating their sales activity when the goals are met. This way of doing business, which is foreign to an employer-employee relationship, helps to account for the industry's high turnover rate, which is in excess of 100% each year.

Simply stated, direct selling is an ideal way for some of these people to earn extra money without experience, without capital, and without having to make a full-time commitment to an employer.

As President Carter stated in a message to the DSA on May 11, 1979:

> The members of your Association create unique opportunities for salespeople who desire to be independent and to receive compensation equal to their effort. These companies make it possible for salespeople to become entreprenuers in their own right.
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> * * *
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> In encouraging small business and in bringing buyers and sellers into useful one-to-one relationships, you are operating in the best tradition of the American free enterprise system.

DSA perceives itself as a progressive trade association dedicated to serving the public interest. We promote the highest level of marketplace ethics and have, for example, supported

various pieces of consumer protection legislation on the municipal, state and federal levels of government. DSA and its member companies have also in the past made considerable efforts to educate their direct salespeople with respect to their income and self-employment tax obligations and their legitimate deductions, through notices given at the outset of the selling relationship and through educational programs. These efforts have not gone unnoticed, as is indicated by the October 17, 1977 letter to an attorney representing a major direct seller from the Office of the Commissioner of the Internal Revenue Service, which acknowledged "a history of concern and cooperation on the part of the Direct Selling Association with the Internal Revenue Service in our cooperative efforts to promote voluntary compliance."

The Role of Independent Contractors in Direct Selling

The people who sell the products of direct selling companies have traditionally operated as independent contractors for reasons that are fundamental to the structure of the industry. The motivation of direct salespeople is directly related to the fact that they in effect have their own business: they control the hours they work, they conduct business away from any office or other fixed location, they keep their own records and books, in some cases they maintain their own inventories, and they pay their own expenses. Direct salespeople are, by any objective

assessment, independent businesspeople and operate in the same fashion as retailers throughout the country, except for the fact that they bring their products to the home of the consumer and do not operate from any fixed retail location. They do not perceive themselves as employees, nor do they wish to be so treated. They generally sel. to their peers within their own communities, to their friends and neighbors. Each year they contact three out of every four homes in America. According to a Lou Harris study, over the course of a year 8 percent of the homes in this nation will include someone who earns money as a direct salesperson, and an additional 15 percent of America's homes have someone in them who previously acted as a direct salesperson.

The independence of the operations of direct salespeople is a crucial factor in the decisions of individuals to become direct salespeople. Our Lou Harris study of direct salespeople found that they rated their own independence, being their own bosses, as the most important element of their sales work, even more important than the specific income they received, which was a close second. This person who sees himself or herself as an independent businessperson is the heart of the direct sales industry.

The success of direct selling companies is a function of the size and capability of its sales force. Each company

strives to expand its sales force, and competition among direct sales companies for salespeople is keen. Consequently, direct selling companies minimize their additional fixed costs for increasing the size of their sales forces and create wide opportunities for marginal workers to enter direct selling. The increased size of the sales force and the minimal administrative costs associated with adding salespersons are key economic factors in the growth of direct selling. Since direct selling constitutes only one to two percent of all retailing, the opportunities for marketplace growth for direct selling companies and opportunities for people to become individual direct salespeople are very substantial.

For all these reasons the use of independent contractors is fundamental to the structure of the direct selling industry. For tax purposes the Internal Revenue Code has long respected this status of independent contractors as determined under the common law. Traditionally, in the direct selling industry the tests for that status imposed by the common law were clearly met, and direct salespeople were treated as independent contractors for tax purposes without substantial dispute.

However, in recent years the Internal Revenue Service has adopted an increasingly aggressive and unjustified audit position of challenging the independent contractor status of a broad group of individuals, including some direct salespeople.

The most prominent example, and the test case, in the direct selling industry involved Queen's-Way to Fashion, Inc., a direct selling company subsequently renamed Aparacor, Inc. The IRS challenge culminated in a decision by the U.S. Court of Claims (Aparacor, Inc. v. United States, 556 F.2d 1004, 1977). In that case the Court sustained the independent contractor status of the direct salespeople and stated that the IRS assessment "represents a radical departure from the traditional common law concept" (556 F.2d at 1012). While the company won the case, it was a costly victory; the company's growth and development were set back for years pending the outcome of the litigation. */

The unjustified attacks on the independent contractor status of direct salespeople illustrated in the Aparacor, Inc. case cannot only immobilize a company's operations, but also create huge retroactive assessments which can jeopardize the financial well-being of a direct selling company. In challenging a company's treatment of individuals as independent contractors, the IRS assesses the company for the full amount of income taxes which it asserts should have been withheld were all its independent contractors treated as employees, plus both the employee and

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*/ A second case, involving Beeline Fashions, Inc., was subsequently settled to the company's satisfaction permitting the company to continue its previously established independent contractor treatment of its salespeople.

employer share of FICA taxes and FUTA taxes. These amounts have been assessed in many cases even though the individual treated as an independent contractor has in fact paid the full amount of income taxes and self-employment taxes which he or she owed. In these cases the IRS assessments have resulted in double tax, since income taxes for the same individual would both be paid by that individual and withheld from the company, and similarly both FICA and self-employment taxes would be paid. In order for the company to reduce this double tax, it has the burden of locating its reclassified independent contractors and obtaining from them information regarding their tax payments; the IRS will not assist the companies in this regard.

Fortunately for the direct selling industry and its independent contractors, the IRS has had no success in attempting to reclassify direct salespeople as employees. In fact, within the last year the IRS has even issued private rulings affirming the independent contractor status of various direct salespeople.

Thus, direct selling companies believe that the common law provides the most appropriate basis for determining independent contractor status, as long as the common law requirements are fairly applied and interpreted by the Internal Revenue Service. These requirements for determining independent contractor status have also been applied in other areas of federal and

state law, such as pension rules, state unemployment compensation and equal employment opportunity requirements. The primary concern of the industry, therefore, with respect to legislation before this Subcommittee, is that the common law principles for determining independent contractor status for tax purposes be preserved, and equally importantly, that the principal characteristic flowing from that status -- treating salespeople for tax purposes as the independent businesspeople that they are -- be maintained.

S. 736

The Direct Selling Association supports S. 736, introduced by Senator Dole. This bill deals with the most important problem in this area -- the problem of IRS challenges to independent contractor status. It is our belief that the bill deals with this problem in a judicious and reasonable manner by establishing a safe harbor to provide certainty for the government, direct selling companies and individual independent contractors. The bill establishes five tests which must be met for an individual to qualify for the safe harbor. These tests include key elements from the traditional common law requirements: control over time and hours worked, control over the place of work and the receipt of income dependent solely upon the

entrepreneurial talents and desires of the individual. Furthermore, the bill adds requirements to insure that independent contractors are aware of their status and the consequent income and employment tax reporting requirements and to insure that the companies with which independent contractors do business provide all required reporting of information to the Internal Revenue Service.

It should be emphasized that these tests impose certain burdens on some specific companies in the direct selling industry, as well as on many companies in other industries desiring to utilize the safe harbor. For example, all companies not previously doing so will be required to adopt written contractual provisions and a separate written notice of each salesperson's status and tax obligations. We believe these burdens are not unduly onerous and are worthwhile to resolve with certainty the fundamental question of status and to insure that independent contractors are fully aware of their tax obligations.

The Treasury Department has criticized S. 736 as allowing significant numbers of employers to switch the status of their employees to independent contractors. We believe that Treasury has vastly overstated this possibility. When the relationships between employers and employees in specific

industries are examined in detail, we believe that the only realistic conclusion to be reached is that the switching will not occur. Nonetheless, if the Subcommittee is concerned about this possibility, and concludes it to be probable, a number of alternative provisions to prevent this switching can be explored. We would be glad to work with you to explore various such provisions.

We emphasize that the support of the Direct Selling Association for S. 736 is based primarily on its safe harbor approach. The DSA could not support this or any other bill which would replace the common law with a specified statutory test. By preserving the common law means for attaining independent contractor status, the bill retains the flexibility that the common law provides -- so that new companies and new ways of doing business can be accomodated as they arise. This flexibility is in our view crucial to any status determination for tax purposes and is important to the well-being of our economy.

We thus support S. 736 because it permits those companies desiring certainty against IRS challenge to have that certainty by meeting its safe harbor requirements. At the same time the bill avoids forcing companies and independent businesspeople into arbitrary and restrictive methods of operation in order to remain independent contractors.

Administration Proposals

The Administration has made several proposals relating to independent contractors but has failed to address the most important problem -- that of unjustified IRS challenges to the traditional requirements for obtaining independent contractor status. Thus, even if their proposals were enacted, which we oppose, the uncertainty and litigation which has characterized the past few years, and which is the reason why this matter is before the Subcommittee today, would continue.

Instead of attempting to solve the central status question, the Administration's proposals would further complicate this area of the law by requiring withholding on independent contractors and increases in the self-employment tax, both of which we vigorously oppose. The Administration also proposes increased information reporting and certain procedural changes, parts of which we would not oppose.

Withholding

The Administration has proposed 10% withholding on independent contractors apparently because it has concluded that compliance among independent contractors is lower than is desirable. Its conclusions of the level of compliance are based on an IRS survey of compliance in various industries.

We have reviewed this study, with the assistance of Robert R. Nathan Associates, Inc. Their statement, which we have included in the record, includes a detailed analysis of the IRS study. It indicates that, in general and specifically with respect to direct salespeople, the IRS study is seriously flawed and does not provide a proper basis for making a major structural change in our tax system. For example, the study is not based on a representative sample of independent contractors generally or of direct sellers as they are generally thought of when one considers this industry. The sample of individuals was drawn only from tax cases where employment status was under dispute, not from a random sample. To our knowledge no DSA member company was audited or otherwise approached for this study, nor to our knowledge was any independent contractor who sells the products of any member company. Moreover, the occupations of the individuals included in the study are inconsistent with the known characteristics of independent contractors generally and direct sellers in particular. We know of few if any salespeople in the direct selling industry who could be classified as "unskilled labor," "skilled labor," "driver," "clerical" and even as "entertainer." Yet the Treasury study indicates that a substantial number of such individuals were included in the definition of the "direct selling" industry; for the entire sample almost one-half of the individuals were classified as "skilled" or "unskilled" workers.

This lack of representativeness of the individuals surveyed distorts the level of compliance stated in the study for the industry. The Treasury study shows that compliance is substantially higher within the industry for individuals whose jobs are categorized as "sales," "professionals," and "manager, distributor," all of which are the types of jobs most typical in the industry.

Moreover, the percentage figures used by the IRS and Treasury in describing the study substantially overstate the size and effect of noncompliance even assuming the correctness of the data underlying the IRS study. The study measured the amount of "compensation" reported by independent contractors, but did not define "compensation" as net income. Thus, individuals whose expenses reduced their income to zero were treated as not in compliance -- even though they had no taxable income from their independent contractor activity. Furthermore, individuals whose total income was below the level required to file tax returns were excluded in computing rates of compliance despite the fact that these individuals clearly are in compliance.

The most important and relevant statistic to the Congress with respect to noncompliance should be the percentage of total taxes of the relevant groups which go unreported, not the

percentage of unreported gross income or even net income, because this statistic measures the actual "slippage" in the tax system and the actual revenue loss to the Treasury. Yet this statistic is nowhere present in the IRS study, although it could have been estimated from the raw data collected. From the data presented by the study, however, it can be determined that the percentage loss of taxes is substantially lower than the percentage of individuals not reporting income. This results because the IRS study clearly shows that nonreporting is the lowest among higher income individuals, who under our progressive tax system pay most of the taxes. Thus, even assuming, arguendo, that the IRS study were representative, RRNA believes that for the independent contractors and the direct salespeople included in the sample the true rate of compliance, as measured as a percentage of taxes collected, is likely to be 90%. Consequently, we believe that the IRS study does not provide a basis for concluding that the level of noncompliance of individual independent contractors in the direct selling industry requires drastic action or draconian remedies. */

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*/ The Treasury study is also inconsistent with prior studies. In 1977 a GAO study concluded that "those taxpayers involved in employee/self-employed redeterminations had generally paid their income and social security taxes" (General Accounting Office, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977 at p.24). The GAO finding was

[Footnote continued, p.17]

Even if it were shown that compliance levels among independent contractors generally has been less than is desirable, withholding as applied to direct sellers is not the solution to the problem for several reasons. The majority of direct selling companies and independent contractors do business with each other through what is commonly called a "buy-sell" relationship. Under this method of operation an independent contractor actually buys products from the supplying company and then resells those products to his or her customers or to lower level distributors. The company supplying the products to the independent contractor thus makes no payment to that individual from which taxes could be withheld. The independent contractor receives compensation only through the payments of consumers or subdistributors buying products directly from that person. The only payment on which taxes could be withheld is this payment by the consumer or subdistributor, which is obviously impossible as a practical matter. Thus, the Administration's withholding proposal with respect to these independent contractors is not in

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*/ [Footnote continued from p.16]

supported by IRS data gathered pursuant to its Taxpayer Compliance Measurement Program (TCMP). That data indicated that for returns filed in 1974 independent contractors and other independent businessmen reported 96.7 percent of their gross receipts. Other TCMP data has shown an 89 percent compliance rate among direct salespeople filing a Schedule C with their returns (as set out in an October 17, 1977 letter from the office of the Commissioner of the Internal Revenue to Harold J. Heltzer, Esq., representing one of the largest direct selling companies).

fact withholding at all. Rather the Administration proposes that the companies that sell products to independent contractors send a bill to the independent contractors for their income and self-employment taxes at the same time they charge them for their products. The independent contractors are being asked to send their tax payments at least in part to the company or companies with whom they do business rather than to the Treasury. We believe that this proposal constitutes a major new departure on the part of the Treasury Department to involve the private sector in the collection of taxes much beyond what is done under normal withholding arrangements.

Moreover, the proposal would apply this major departure in the most unworkable of circumstances. For example, in buy-sell relationships products may be purchased from the supplying company before or after the salesperson has received an order from a customer; some direct salespeople maintain varying inventories of products for substantial periods of time. In addition, the company which sells the goods to the salesperson does not know whether the products were in fact resold, since many salespeople retain a certain portion of their products for their own personal use (as much as 20% for some product lines), for gifts or for sale to relatives or friends at or near cost. Even assuming that all the products were resold by the independent

contractor, the company has no way of knowing at which price that sale occurred, because under the antitrust laws the direct selling companies cannot set resale prices for their products. Thus, direct sales companies do not typically even know what the actual gross receipts are of the independent contractors who buy their goods, much less what the gross or net income of any individual is. Therefore, the amount to be withheld under the Administration proposal would bear little relationship to the actual tax due by the independent contractor.

Furthermore, many independent contractors maintain inventories and an additional number pay for the products they purchase before they receive any payments for the resale of those products to consumers. Requiring that independent contractors make an additional tax payment to their supplying company at the time they pay for their products will place an additional cash-flow burden on these salespeople. Since most of these salespeople are truly small businesspeople, without easy access to bank financing and without substantial cash reserves to invest, this cash-flow drain can be a significant disincentive to their continuing in the business.

The mechanical problems of implementing withholding for direct salespeople is compounded by the fact that certain direct salespeople are part of multi-tiered sales and distribution systems. In such a system a company utilizing direct salespeople may itself

sell only to a few hundred distributors/salespeople, who maintain inventories and resell their products to thousands of second-tier direct salespeople, many of whom may in turn resell to an even larger number of third-tier salespeople before a sale to the consumer is finally made. Under this method of distribution, it would be extremely difficult to determine who should withhold what amount on which transactions.

The unworkability of withholding is not limited to companies operating through buy-sell relationships. Even among those which utilize "commission" relationships, many companies operate through so-called deposit commissions under which the consumer's down payment for the product is retained by the direct salesperson as his or her "commission," with the remaining payment made by the consumer to the company. In this situation, like in buy-sell situations, there is no payment from the company to the direct salesperson on which taxes can be withheld; presumably here too the Administration's proposal would require that the company send a bill to the direct salesperson for his or her tax. Moreover, commission direct salespeople also retain a significant portion of the products they obtain from a compny for personal use or for gifts or sales at discount to friends or relatives. In these cases the amount withheld would bear little or no relationship to the actual profits and taxes due by the salesperson. Finally, commission and buy-sell direct selling

companies compete directly with each other for sales and, more importantly, for salespeople. If a withholding system applied to the commission companies alone, a major competitive disadvantage would result to those companies in recruiting new salespeople and in their overhead expenses. Some companies could be forced to change their way of doing business, causing considerable expense to the companies and the loss of income earning opportunities to direct salespeople; others which could not alter their marketing system might not be able to survive.

The difficulty both buy-sell and commission companies (and their upper tier distributors) would have in determining the appropriate amount to bill an independent contractor under the Treasury withholding proposal, the administrative costs of billing and collecting the taxes from the independent contractors -- plus the normal clerical and accounting costs required in issuing statements comparable to W-2s, preparing quarterly 941 and annual 940 statements, filing 501 deposit withholding tax forms and making such deposits -- all these factors will result in substantially increased costs for companies who operate through direct salespeople. Surveys taken by RRNA indicate that these costs on a continuing basis could total $70 million per year for all direct selling companies.

This $70 million of annual costs to the companies might be justifiable at least from the government's point of view if

substantial additional tax revenues would be collected as a result of the institution of withholding. However, the same RRNA studies conclude that the increases in revenue under the Treasury proposal will be nominal. For 1975, the latest year for which figures are available, the total tax liability of direct salespeople on their income from the direct sales is estimated to be $190 million. As discussed above, even statistics from the IRS compliance study indicate that most of the income of direct salespeople is reported and that an even higher percentage, as much as 90%, of the taxes owed by direct salespeople are currently collected. Since the Treasury Department has previously stated that its withholding proposal would raise tax compliance to about 90 percent, the proposal cannot possibly produce any substantial increase in the taxes collected from direct salespeople. RRNA has estimated that, even based on the IRS compliance study, the increased income tax revenue from the withholding proposal would likely have been less than $30 million in 1978. It is thus likely to cost direct selling companies more to implement the Administration's proposed withholding system, which costs will reduce their own Federal income taxes, than it will raise for the government in increased revenues. Surely in these circumstances a major change which vitally affects the industry is not warranted.

Withholding will also have a major impact in the direct selling industry because it will increase a direct selling company's start-up costs in adding new part-time and part-year salespeople. A company will be required to put each person who

decides to buy that company's products for resale into its accounting system for withholding purposes regardless of whether that individual may make many or only a few sales, or even make no sales but keep the products for gifts or personal use. Companies thus will be given an incentive to change their operations to enable them to increase their chances of recouping these increased start-up costs by utilizing fewer part-time and part-year salespeople and more full time salespeople. The end result will be that many individuals, particularly those who have the lowest incomes, will no longer participate as direct salespeople and will lose the opportunity to supplement their family income for special needs.

Finally, we oppose withholding because it will strike a major blow against the most fundamental element in the success of this industry: the image by the independent contractor of himself or herself as an independent businessperson. Direct salespeople do not want jobs, they want opportunities to be their own bosses, to work their own hours and to relate their reward to their own efforts. Withholding, on the other hand, is the badge of employee status. It symbolizes a lack of control by the salesperson over his or her own affairs. It is the Government telling him or her that, unlike other businesspeople, the direct salesperson is not permitted to control his or her own business affairs, to compute

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and pay his or her own taxes. Consequently, individuals who want that control over their own affairs, individuals who want to be free of any corporation's control over their affairs, will be more likely to leave the direct selling industry to seek less restricting opportunities and less likely to enter the industry in the future. We believe that, although this intangible negative factor cannot be quantified, it may be the most important of all the reasons why withholding on direct salespeople over the long run will be a major detriment to the economic well-being of this industry. It also indicates why it is not in the national interest to place impediments on individuals wishing to start their own businesses to provide or supplement family income by altering the most appealing element the direct selling industry offers: the opportunity to be one's own boss.

Information Reporting

Although we vigorously oppose the Administration's withholding proposal, we do recognize the need to take reasonable steps to insure that income and self-employment tax compliance among independent contractors is as high as is practically possible. We believe that this goal can be accomplished by taking several steps to improve information reporting, all of which can be accomplished without incurring the costs and disruptions which would inevitably result from withholding.

First, we agree with the Administration's recommendation that the companies paying compensation to independent contractors should be required to send a copy of the existing Form 1099 to the independent contractor in all cases where it is currently required to be furnished to the government. In this way independent contractors will receive a timely reminder of their tax obligation each year. More importantly, individuals will be made aware that the information on the Form 1099 is in fact sent to the Treasury.

Second, we also agree with the Administration's recommendation that penalties for failure to file the Form 1099 on the part of any company should be increased, and we would add that the penalties should be enforced. Treasury has stated that fewer than 60 percent of 1099s currently required to be filed with the IRS are in fact filed. We believe that the IRS should be encouraged to devote more of its manpower to ensuring that these forms are filed in a correct and timely manner. We regret that in its compliance study the IRS did not correlate the level of compliance with the filing of 1099s; we believe such a correlation would have indicated that accurate and complete 1099 reporting does lead to increased compliance.

Improving the IRS's ability to match 1099 Forms and individual tax returns is obviously also important, and we

support efforts to do so. Commissioner Kurtz has testified elsewhere that IRS's matching ability will dramatically increase within the next few years over past years. This action alone could result in an increase in compliance.

We believe that modifications could also be made to the Form 1040 and the accompanying instructions to highlight for individuals the requirements for self-employment tax payments and to help the IRS determine from the first two pages of a Form 1040 whether or not an individual should be paying self-employment tax. We believe such modifications are possible without seriously lengthening or complicating the current 1040 Form.

Finally, we believe that much of any underreporting that may occur results from ignorance on the part of independent contractors regarding what their obligations are and how to fulfill them. The reporting requirements of S. 736, discussed above, the Administration proposal to send a Form 1099 to each individual and the redesign of the income tax Form 1040 will do much to alleviate this cause of underreporting. Additional help could be obtained through focused educational efforts by the IRS and the companies involved. DSA member companies would be glad to participate in such efforts.

Self-employment tax increases

A third proposal which Treasury has made on behalf of the Administration is to increase the self-employment tax rate

to the combined FICA tax rate on employers and employees and to give the self-employed a deduction or credit for some portion of the increased tax. Although we understand that this proposal is not before this Subcommittee at this time, we would like to make clear that we would oppose this proposal. The self-employment tax rate was originally established to insure that the Social Security system would be actuarially sound as it applies to the self-employed. Our RRNA studies indicate that this is still the case. In fact, it appears that direct salespeople are among the few groups that pay more into the Social Security system in taxes on their income from direct selling than they receive in increased Social Security benefits as a result of that activity. An increase in the self-employment tax rate would only exacerbate this situation.

Proposals for Procedural Change

The final proposal which the Administration has made would limit the IRS's authority to make retroactive assessments of income tax withholding and the employee's share of FICA taxes (but not the employer's share of FICA taxes) to a penalty of 10% of the compensation to individuals whom the IRS claims should have been classified as employees. In cases where the company had a reasonable basis for treating the individual as an independent contractor, the penalty would be abated, as long as the company

withheld amounts required under the Administration's independent contractor withholding proposal.

We firmly support proposals to eliminate the IRS authority to make retroactive assessments since in many cases the assessments are likely to result in a double tax being paid. However, we would not oppose the Administration's basic proposal only if two modifications were included. First, because we oppose the Administration's withholding proposal, we believe that obtaining the benefits of relief from retroactive assessments should not be tied to any such proposal. The fact that such assessments can result in a double payment of tax is in itself sufficient grounds for not permitting the assessments where the taxpayer involved has a resonable basis for, or has made a good faith judgment in, classifying individuals as independent contractors rather than employees.

Second, we believe that the penalty for an incorrect classification should not be related to the amount of compensation received by individuals, since at a ten percent rate that penalty can in certain cases be larger than the amount which would have been required to be withheld if the IRS made a withholding tax assessment. It would be more equitable to base the penalty on the amount of tax -- income tax and the employee's share of FICA -- which the IRS asserts should have been withheld,

for example, 10% of those taxes. Such a penalty would accomplish the essential purpose for which Treasury desires it to be imposed (*i.e.*, to deter companies from frivolously treating individuals as independent contractors without any basis at all) without risking a result no less inequitable than is reached today through retroactive assessments. Alternatively, if it is believed that the penalty should be based on compensation instead of a percentage of taxes, the penalty should be reduced substantially below the 10% level which the Administration proposes in order to minimize the likelihood of a penalty in excess of actual liability if assessments had been permitted.

Conclusion

The important problem which this Subcommittee must resolve today is the question of what individuals can qualify for independent contractor status. The Administration proposals do not address this problem. S. 736 does resolve this problem and does so in a reasonable and responsible manner by providing a set of safe harbor rules for attaining independent contractor status while preserving the flexibility provided by the common law. We strongly urge its adoption.

At the same time the Administration's proposal for withholding on independent contractors should be rejected. It

is based on a study which does not provide a valid basis for concluding that substantial noncompliance exists among direct salespeople. It would force direct selling companies to incur substantial costs, would cause substantial complexity and administrative burdens for companies and direct salespeople alike, and would significantly increase the costs of allowing individuals to participate in the direct selling industry on a part-time, part-year basis. Also, our studies indicate that withholding would raise no more than nominal revenues from direct salespeople, revenues which may well even be less than the additional annual costs incurred by direct selling companies in administering the system.

As an alternative, concerns regarding taxpayers noncompliance should be directed at improved information reporting procedures. Such improved reporting can, we believe, improve compliance to the same extent as withholding without causing the disruptions and costs to the industry which withholding produces.

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AN ECONOMIC ANALYSIS OF INDEPENDENT CONTRACTORS AND THE DIRECT SELLING INDUSTRY

SUMMARY

The economic vitality and future of the direct selling industry is directly dependent on the independent contractor status of the several million people who work as direct salespersons. Three issues have emerged which affect the role of the independent contractor and the direct selling industry: (1) defining the status of independent contractors as distinct from employees; (2) a proposal to extend tax withholding to independent contractors; and (3) a proposal to increase the social security tax rate of the self-employed.

Because of the economic characteristics of direct salespersons -- predominantly part-time, low average income, ease of entry and exit and high turnover -- and the economic structure of most direct sales companies -- dependent on a large sales force whose marginal cost to the company is low -- each of these issues has direct and important consequences for the industry.

The economic viability of the direct selling industry requires certainty in defining the status of independent contractors. Continuation of the uncertainty which has permeated this issue since 1975 can only dampen growth and innovation by existing companies and hinder the entry of new firms, thereby also foregoing income earning opportunities for direct salespersons. The significance of this issue is illustrated by the consequences if direct salespersons were to become employees: up to two-thirds of the direct sales

force would be eliminated with a serious contraction in industry sales and profits. The benefits of providing definitive criteria to assure certainty (as in S.736 and H.R. 3245) will not be accompanied by a shift of persons from employee status to that of independent contractor.

The proposal to extend tax withholding to independent contractors should not be adopted. This proposal, constituting a major tax change, emanates directly from a recent Internal Revenue Service study of tax compliance of independent contractors. The study's sample is not representative of independent contractors, nor can conclusions be drawn from this study concerning tax compliance of direct salespersons. Because of its many limitations, the IRS study should not serve as the basis for introducing a fundamental tax change.

Tax withholding would have serious economic ramifications for the direct selling industry. Reduced sales and profits would be incurred due to salesperson terminations because of tax withholding and as the costs of recruiting new salespersons increases. In addition, the industry would bear costs for administering a tax withholding system -- estimated to be $10 million for start-up alone and $70 million annually for continuing costs. Small firms in particular would be adversely impacted.

In contrast to these costs, the additional public revenue which would be generated by an extension of tax withholding to direct sellers would be modest at best.

The majority of direct salespersons earn less than $675 and therefore have little or no tax liability. Even when using the compliance results of the IRS study, the revenue gain from direct salespersons would be less than $30 million, or less than one-half of the economic costs of tax withholding to the industry. Net revenue gains will be less since corporate income tax from direct selling companies will decline due to contraction in sales and increased administration costs.

Improvement in tax compliance is an important public policy goal. Alternative approaches to improving compliance which have lower net economic costs than tax withholding should be considered. One alternative is to extend and strengthen the existing information reporting system.

An increase in the social security tax rate for the self-employed is not warranted. The present difference in SECA and the combined employee-employer FICA rates does not induce shifts of persons from employee to self-employed status thereby reducing contributions to the trust funds. Due to their social and economic characteristics and patterns of work, most direct sellers receive much less in benefits than they contribute to the social security system; increasing the SECA rate would accentuate this inequality. Moreover, the additional contributions which might be realized from direct salespersons by increasing the SECA tax would be nominal, no more than one-hundredth of one percent of total social security contributions.

I. The Direct Selling Industry: Its Economic Structure and Issues Affecting Its Future

The development and continued growth of the direct selling industry is directly dependent on the independent contractor status of the several million people who work as direct salespersons. Several issues have emerged, and are now in the form of proposals being considered by Congress, including the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, which affect the integral role of independent contractors. The purpose of this paper is to describe the economic and social consequences of these issues as they affect the direct sales companies, direct salespersons and the government itself.

Issues Affecting the Industry

There are three distinct issues now under consideration which relate specifically to independent contractors and thereby impact directly on the direct selling industry. The first issue concerns the need for certainty in the definition of an independent contractor. Such contractors are distinguished from employees for tax purposes in the I.R. Code and Treasury Regulations in terms of the common law. Several years ago the Internal Revenue Service initiated an effort to reclassify many independent contractors as employees, departing from the Service's own position in its revenue rulings and, more importantly, from the Code, regulations, and case law. The Service applied this new position "retroactively," resulting in large tax assessments and

jeopardizing many businesses relying on independent contractors. The uncertainty which this created led Congress in 1978 to pass a one-year moratorium on IRS actions while Congress addresses the status issue directly.

A second issue involves a proposal by the Department of Treasury to impose income tax withholding on independent contractors. Although the procedures and detailed features of this tax withholding proposal have not yet been worked out, its essential feature is a standard 10 percent withholding on compensation earned by independent contractors. The proposed tax withholding is intended to improve compliance by independent contractors in the payment of income and social security taxes.

The third issue concerning independent contractors and affecting the direct selling industry is a proposal for increasing social security payments by independent contractors. While a formal legislative proposal has not been made, it is understood that the Department of Treasury and the Social Security Administration are considering a proposal to increase the SECA tax rate, now approximately 1.5 times the FICA rate for employees, to twice the FICA rate (equal to the combined employer-employee rate), with provisions for individuals to deduct one-half of the payment from income taxes. This proposed increase in SECA taxes is premised on the assumption that independent contractors, as well as all self-employed persons, do not "pay their way" in the social security system.

Each of these three issues concerning independent contractors is analyzed in the succeeding sections of this paper. The focus of the analysis is on identifying (and measuring where possible) the economic and social consequences for the direct selling industry and the several million persons engaged in direct selling as independent contractors. As an essential background for this analysis, the salient economic characteristics of the direct selling industry and direct salespersons are first described.

Characteristics of the Direct Selling Industry

The direct selling industry consists of an estimated 500 to 600 companies with a total sales volume of $8 billion a year. The vast majority of these companies are small business concerns, with the typical company having annual sales in the range of $2 to $3 million. There are few large companies, with only 10 firms having annual sales above $100 million. This industry is unique in the retail merchandising sector because of its reliance on person-to-person product demonstrations and the mode of delivery of services provided by its salespersons.

At any point in time there are approximately 2 million active salespersons. During the course of a year, however, another 2 million persons enter and leave this industry, a fact which is particularly pertinent to the issues facing the industry.

As indicated by the number of salespersons, direct selling companies rely on a large force of salespersons.

The ease of entry into direct selling and the ability to vary hours, type of work and level of effort are features which have enabled the direct selling industry to develop an efficient method of consumer product distribution. Companies have little or no additional fixed costs and only modest variable costs associated with increasing the size of their sales force. As a consequence, there is an incentive for the companies to create the largest opportunities possible for entry into direct selling. The size of the salesforce and the low marginal cost for adding salespersons are the central economic factors in the development and growth of direct selling companies.

Within this basic industry approach, however, there is substantial diversity. A wide variety of different direct selling methods are used, employing different marketing plans, financial arrangements and company-salesperson relationships. Commission companies and buy/sell companies are the predominant types with the latter accounting for 80 percent of total salespersons. This diversity within the industry increases the difficulty of applying standard changes across it.

Characteristics of Direct Salespersons

Almost 90 percent of direct salespersons work on a flexible part-time basis averaging 10 hours per week.[1]

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1. Figures in this section are based on survey data found in Louis Harris and Associates, Inc., A Report on Direct Selling Salespersons, commissioned by the Direct Selling Education Foundation, October 1976. The economic

These are persons who are married women with children, persons with physical disabilities, minorities, older persons, members of low income families for whom direct sales income can be a substantial portion of family income, and persons temporarily unemployed. These people rely on direct sales because of the ease of entry into the industry, the flexibility of working conditions and a variety of social motivations. These groups would be most adversely affected by the three issues described earlier, since the reduction in income opportunities will affect first and most directly the part-time salespersons.

Married women with children constitute a large percentage of all direct sellers, far in excess of their percentage in the labor force as a whole, and most of whom work on a part-time basis. The main reason these women are limited to part-time work is home responsibilities. Fifteen percent of the direct sales force are from minority groups; 10 percent of all direct sellers have a disability (of which 71 percent are without other employment); and 5 percent of the total are 65 years of age or over.

Direct selling generally provides the means of augmenting family income, rather than being the major producer of family income. Hence it is relied on by persons not able

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and social characteristics of direct salespersons are analyzed more fully in Robert R. Nathan Associates, Inc., Summary of the Economic and Social Impacts of Changing the Independent Contractor Status of Direct Salespersons and of Extending Tax Withholding to the Direct Selling Industry, Washington, D.C. March 10, 1978.

to hold full-time employment or those at the lower levels of earnings potential.

The earnings profile of direct salespersons is particularly germane to the three issues concerned with independent contractors. The distribution of estimated direct seller net earnings (shown in Table 1) reveals that a very small number of salespersons accounted for a very large proportion of direct selling income: 6 percent of the sellers have almost half the income, and only 11 percent of the sellers account for almost two-thirds of the income. In contrast, 57 percent of salespersons account for only 10 percent of net income.

The average income in 1975 for all salespersons, derived from the Harris survey data, was approximately $2,200; one-half of the salespersons earned less than $675 for the year. Low as these income figures are, they overstate significantly the net taxable income of direct sellers because the income estimation procedures using the Harris survey information could not fully reflect the operating expenses of direct salespersons.

In summary, the economic and social characteristics of direct salespersons -- predominantly part-time work, ease of entry, involvement by persons who are not likely to have other income opportunities and relatively low average income -- reflect directly the key economic characteristics of the industry: reliance upon a large and expanding sales force whose marginal cost to the direct sales companies is low.

Table 1. Direct Sales Industry: Distribution of Direct Salespersons and Total Net Direct Sales Income, by Direct Sales Income Classes, 1975

Annual direct sales net income classes	Distribution of salespersons: Percent of Sellers	Distribution of salespersons: Cumulative percent of sellers	Distribution of net income: Percent of total net income	Distribution of net income: Cumulative percent of net income
$0-299.................	15.7	15.7	1.4	1.4
300-499...............	19.8	35.5	3.4	4.8
500-699...............	21.1	56.6	5.7	10.5
700-999...............	6.0	62.6	2.2	12.7
1,000-1,499...........	12.8	75.4	6.6	19.3
1,500-4,999...........	13.9	89.3	17.5	36.8
5,000-9,999...........	4.7	94.0	15.2	52.0
10,000 and over.......	6.0	100.0	48.0	100.0
	100.0		100.0	

Source: Prepared by RRNA from the Louis Harris and Associates, Inc.: A Survey of Direct Selling Salespeople conducted for the Direct Selling Education Foundation, October 1976.

II. The Need For Certainty In Defining Independent Contractor Status

The existence of the direct selling industry in its present form and level of sales is dependent on the status of direct salespersons as independent contractors. The vast majority of direct selling companies -- and salespersons -- require certainty and continuity in the definition of such status. For many years the common law tests for distinguishing independent contractors from employees produced consistent and workable results. As noted earlier, however, the Internal Revenue Service began to reclassify independent contractors as employees, creating an environment of uncertainty for many individuals who had functioned traditionally as independent contractors and for firms whose development and economic structure are based on these independent contractors. Legislation introduced in the Senate (S. 736) and in the House of Representatives (H.R. 3245) is intended to provide definitive criteria for establishing the status of individuals who are functioning as independent contractors, thereby removing much of the uncertainty on the status of independent contractors.

The importance of workable and definitive criteria for defining an independent contractor cannot be overestimated for the direct selling industry. The key economic factors for most direct selling companies -- a large salesforce with a low marginal cost -- and the predominance of part-time and intermittent salespersons mean that the relationship between companies and salespersons is both crucial and sensitive to change. Experience in the industry has shown that even

modest changes in the relationship (changes in marketing plans, financial arrangements, or method of payment) results in large terminations of salespersons, which in turn has reduced sharply company sales and profits.

Given the crucial role of independent contractors for the direct selling industry, uncertainty in defining independent contractors can only result in dampening growth and innovation by existing companies and hinder the entry of new firms in the industry, thereby also foregoing new income earning opportunities for direct salespersons. These consequences of uncertainty will be most pronounced for smaller and newer firms, and particularly those dependent on a large part-time salesforce, which do not have the financial resources to accommodate such changes.

The significance of this issue to the direct selling industry is illustrated by the results of an analysis of the impacts on the direct selling companies and salespersons should a change occur in their independent contractor status.[1] It was determined that a change in the status of the nation's direct salespersons, from independent contractors to company employees, would result in a restructuring of the entire direct sales industry.

The costs to the industry of changing the status of independent contractor salespersons are direct and indirect.

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1. A full discussion of this analysis is presented in Robert R. Nathan Associates, Inc., Summary of the Economic and Social Impacts of Changing the Independent Contractor Status of Direct Salespersons and of Extending Tax Withholding to the Direct Selling Industry, Washington, D.C. March 10, 1978.

The direct costs consist of the administrative costs associated with payroll and tax withholding accounting; IRS forms and report preparation and records retention; sales management cost increases, including the recruiting and training of sales managers and provision of office space; social security and unemployment taxes; employer-employee insurance and increased product liability insurance; workmen's compensation insurance; state and local licensing and taxes; and restructured pension plans and extension of other employee fringe benefits. While the magnitude of these direct costs cannot be estimated precisely, an analysis of selected direct selling companies indicated that the combination of these direct costs would amount to as much as $475 to $500 million, which is equivalent to 8 percent of net sales, or an amount which approximates the after tax net income of direct selling companies. Costs of this order will surely affect the structure, profit and, in some instances, the continued existence of direct selling companies.

The indirect costs of a change in status would be yet more detrimental to the industry. These indirect costs would consist of a substantial reduction in the number of salespersons who would be retained by companies as employees; a consequent significant decline in industry sales volume; and a reduction in the total earnings of salespersons. These impacts would occur because the direct costs associated with a change in status would force the companies to reduce utilization of part-time salespersons. The part-time salesperson is the core of the direct sales force: 89 percent of all direct sellers presently work on a flexible part-time basis averaging 10 hours per week.

Faced with the direct costs associated with employment status, companies would be forced to change their relationship with salespersons to insure that as employees they would generate enough sales and profits to cover all their fixed costs and warrant retention on the company payroll. Any salespersons who could not work substantially full-time could no longer continue as direct sellers.

While the extent of reduction in the number of direct salespersons obviously cannot be estimated with precision, there is no doubt that the magnitude would be large. The reduction could be as much as two-thirds of the present direct sales force. This estimate was derived from discussions with industry executives, an examination of the distribution of sales volume by salespersons under different marketing plans, and an analysis of the potential extent of increase in the marginal and fixed costs of a sales employee. Even if this figure were somewhat overstated, the absolute magnitude of people affected -- at least on the order of one million -- would be substantial.

It should be readily apparent that certainty in defining independent contractor status is essential to the direct selling industry and continuation of income earning opportunities for salespersons. At the same time concerns have been raised that by assuring certainty for existing independent contractors (for example, through S. 736 and H.R. 3245), there may be a large scale shift of persons from employee status to that of independent contractor.

Admittedly, it is difficult to determine whether a shift will occur and what the magnitude of change would be. However, there are reasons to doubt that a shift will occur. Those who argue that a large-scale shift will take place incorrectly assume that employers have the economic leverage to change at will employees to independent contractors. Any large shift in a distinct industry could be readily identified and the appropriateness of the change promptly determined. Equally important, as shown in Table 2, the number of self-employed persons has remained almost constant, increasing by only 5 percent since 1970 compared to a 16 percent increase in the number of employees. The illustration used by the Administration of a 1 percent shift of em-

Table 2. Changes in Self-Employed and Wage-Salary Workers, 1970-77

Item	Self-employed	Wage-salaried workers
Number of workers in 1970	7,593,000	84,248,000
Number of workers in 1977	7,963,000	97,699,000
Absolute change during 1970-77	370,000	13,451,000
Percentage change during 1970-77	4.9	1.6

Source: Bureau of Labor Statistics.

ployees seems small on the surface but in fact represents an unlikely structural change, increasing the number of self-employed persons by 12 percent. It is difficult to envisage that the historical pattern would be altered so substantially with the definition of independent contractors as set forth in the proposed legislation.

III. Direct Sellers and Tax Withholding

The proposal by the Department of the Treasury to introduce tax withholding on the earnings of independent contractors poses a serious issue for the direct selling industry. There are inherent difficulties associated with tax withholding in this industry. There are real and substantial costs that would be incurred by direct selling companies, with the likely reduction of income earning opportunities for direct salespersons. Moreover, the net revenue benefits which would be gained with tax withholding are likely to be nominal.

Review of the Tax Compliance Study

The Treasury proposal to extend tax withholding emanates directly from a recent study of tax compliance of independent contractors undertaken by the Internal Revenue Service. Because of the significant change which the Treasury proposal entails, it is important to examine carefully the results of the study, and particularly the methodology of the study.[1]

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1. Some of the results of the study and a brief description of the methodology are contained in the appendix of the statement by Donald C. Lubick, Assistant Secretary of the Treasury, before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, June 20, 1979. Supplemental information was provided by Mr. Lubick to Congressman Richard A. Gephardt in a letter dated July 13, 1979. Requests to the Treasury Department for further clarification on key components of the study are yet to be received.

The IRS study involved audits of 5,152 independent contractors, with the individuals reportedly selected at random from a group of payors whose own cases from the tax years 1976 and 1977 were still under dispute (the dispute presumably being whether the individuals they paid were to be classified as employees or independent contractors). The IRS reported that 47 percent of the individuals audited did not report any of the compensation they were paid for work as independent contractors, and that 62 percent of the individuals made no SECA payments on this compensation. This particular compliance ratio was the focus of Mr. Lubick's testimony and subsequently received the most attention. In terms of the ratio of compensation reported to total compensation, the compliance rates are substantially better (76 percent) and similarly better for total SECA taxes paid (66 percent). Most important, however, the study is silent with respect to a key factor, the ratio of income tax paid to tax liability, which is undoubtedly well above 76 percent.[1] The failure of the compliance study to estimate this compliance ratio -- by far the most significant -- is a major limitation of the study.

This study should not be the basis for introducing a major tax change. First, the methodology and design of the study are seriously flawed. There are several reasons why this is the case.

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1. The reason why this would be the case is that compliance improves sharply as compensation (income) increases, a finding of both this and other IRS studies. Low income, where compliance is poorest, means low tax liability.

- The sample of individuals audited is not representative of independent contractors.
    - The universe of independent contractors is not known, which the Treasury explicitly admits.[1]
    - The sample of workers was drawn only from tax cases where employment status was under dispute.
    - Moreover, the sample was drawn from approximately 57,000 workers which the Treasury has stated is "definitely not representative of the entire population of independent contractors."[2]
    - Although the Treasury describes the selection of workers in the sample as being random, that is not the case.
    - The large number of skilled and unskilled workers in the sample (almost one-half) is not consistent with the known characteristics of independent contractors.
- Acceptable measures of statistical reliability have not been provided, so that the reliability of the compliance rates are not known.
- For many industry occupational groupings in the study the number of workers audited is too small to estimate compliance with statistical reliability.

A second deficiency of the IRS study is the failure to estimate compliance rates correctly.

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1. Letter from Mr. Lubick to Mr. Gephardt, July 13, 1979, p. 7a.
2. Ibid., p. 13a.

- "Compensation" of independent contractors used to calculate compliance rates is not net income (which would be the appropriate measure), resulting in an overstatement of non-compliance by the IRS.

- Individuals whose total income was below the level required to file tax returns were excluded from the compliance estimates -- despite the fact that these individuals are in compliance -- again resulting in an overstatement of non-compliance.

- The IRS fails to estimate the tax compliance rate (the ratio of taxes paid to tax liability), which is the most meaningful of the compliance rates for decisions regarding tax changes. Using the IRS's own data, the tax compliance rate for all 5,152 workers in the study is estimated to be 90 percent.

- The IRS included as non-compliers a large number of workers (estimated to be almost one-fifth of the sample) who the IRS found had no tax liability as independent contractors.

A third general limitation of the study is that information was not obtained from the individuals audited as to whether they received a 1099 form from their payor. Nor were the payors asked whether they sent 1099 forms to the individuals reporting the compensation paid. The lack of these data does not permit a comparative analysis of compliance with information reporting. An analysis is highly relevant for examining proposals to strengthen tax information-reporting requirements as a means for improving tax compliance.

A more specific conclusion concerning the IRS compliance study is that conclusions cannot be reached with respect to the tax compliance of direct salespersons.

First, there is a definitional problem. An industry titled "Direct Selling" is included in the IRS industry classification, but this industry includes a wide range of sub-industries other than direct selling as defined in Section I. At the same time, based on information available, it appears that not all subcategories of industries in the Standard Industrial Classification of "Direct Selling" were included in the study. Thus, there is no single category -- industry or occupation -- in the study which corresponds to direct salespersons. Moreover, the IRS industry identified as "Direct Sales" includes workers with occupations foreign to the industry -- entertainers, drivers and a large number of unskilled laborers.

Second, though the exact number of direct salespersons in the sample is not known, it is clear from the information available that there are too few direct salespersons in the sample for statistically reliable estimates of compliance. This is an important conclusion, not only for the direct selling industry and salespersons, but also because it reinforces the general conclusion that the sample is not representative. As a way of illustrating this point, to achieve a sample variance of 20 percent (variance being a common measure of a sample's reliability and 20 percent being a liberal test) on the compliance rate of direct salespersons, a sample size of about 410 salespersons would

be required. If the sample variance were 10 percent (a more acceptable test), the sample size would have to be approximately 1,600. In contrast, the category in the IRS study most closely corresponding to direct salespersons (the occupation of "sales" in the industry "direct selling") is only 322, with direct salespersons being some fraction of this number.

Improving tax compliance, both on income tax and social security payments, is an important public policy goal. It should not, however, be an end in itself. Rather, specific proposals to improve compliance should involve an explicit comparison between the economic and social costs which the proposal will incur and the expected public revenue gains it will achieve. Moreover, it would be desirable to examine alternatives which improve tax compliance but at lower economic and social costs. These considerations of the Treasury proposal to extend tax withholding to independent contractors -- and specifically direct salespersons -- are examined in the remainder of this section.

Difficulties and Costs Arising from Tax Withholding

Income tax withholding presents administrative difficulties in the direct selling industry which, in turn, cause adverse economic consequences for the companies and salespersons. The direct costs are not marginal, in the sense of just adding more names to the computer files and printing more reporting forms. The administrative difficulties arise from changing the very way most direct selling companies conduct their businesses. Eighty percent of direct sales-

persons buy products at a wholesale price to resell at a retail price. The difference in these two prices is the gross profit, from which salespersons deduct the usual business expenses to arrive at their net taxable incomes. The direct selling companies play no part in the financial calculations of their independent contractors. This relationship is both more distant and complex in those companies which have multi-level distributors.

In order to withhold taxes, there must be a monetary payment by a company to a salesperson. In direct selling, however, it is the companies which receive the monetary payments in the form of wholesale prices paid for products by the independent contractors. If these financial flows are changed to accommodate withholding, the very business foundation and relationships on which the industry has successfully developed must be changed. Companies would need to require remittances from salespersons at retail prices or to ship, C.O.D., the product valued at retail. In either case the company would then remit the commission earned less tax withheld to the salesperson. The change from a wholesale price-based to a retail price-based financial flow could produce major disruptions. From the viewpoint of the independent contractor, it would have an impact on their customary method of operation and their cash flow. They would have less capital with which to buy products for resale because tax withholding would be right "off the top." Monies needed for purchasing additional samples and in-house inventories would be reduced; this, in turn, would adversely affect sales and profits.

Regardless of whether companies pay commissions to or receive payments from salespersons, it would not be possible for companies to determine the net taxable income of salespersons since their expenses incurred for selling cannot be ascertained by the companies. These expenses can be substantial (averaging three-fourths of gross income) and vary significantly among salespersons depending on volume of sales, method of selling and type of goods sold.[1] At best, the companies would only be able to determine gross income before the deduction of salesperson expenses. But even determining gross income is complicated by several factors. The difference between the retail and wholesale prices for goods sold (which is equivalent to gross income) varies among individuals selling for the same company, due partly to different retail prices being charged and partly to the variation in composition of goods sold. Also, companies do not know if the salesperson is ordering part of the product shipped for their personal use rather than for resale. In many product lines, personal purchases account for 15 to 20 percent of total company sales. For those companies utilizing multi-level distributors, estimation of net taxable

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1. The Treasury has suggested that, despite these considerations, determination of taxable income of independent contractors in a buy-sell relationship does not present a problem, citing the case of bakery truck drivers (statutory employees) as an illustration. It is reasonable to expect that the circumstances of bakery truck drivers are substantially different from those of direct sellers: each payor probably has only a few drivers whom he sees on a continuing basis; the drivers for any one payor are selling a homogeneous set of goods; and the drivers' expenses are well known (mainly the cost of transportation and based on a long and continuing experience).

income (or gross income) of individual salespersons becomes an exceptionally complex and costly requirement.

It should also be noted that a flat across-the-board percentage withholding would be regressive as between large and small-volume sales producers. The majority of direct sellers fall into the lower end of the income distribution of the self-employed and thus would be more adversely affected by tax withholding at a flat rate.

Tax withholding, as any change in the industry's financial arrangements, will adversely affect the sensititve company-salesperson relationship. The experience of some direct selling companies has demonstrated the sensitivity of this key relationship: changes in marketing plans, new methods of financing purchases, or changes in the form of compensation have often resulted in large terminations of direct sellers. Though the number of individuals cannot readily be estimated, the introduction of tax withholding will result in a large voluntary termination of salespersons (probably as many as 20 percent) who will view withholding as an imposition on their business arrangements with companies and as a drain on their limited cash flows. For similar reasons, recruiting of new salespersons will become more difficult, not only reducing the number that might otherwise be selling but also increasing the marginal costs of adding persons to the sales force. As a consequence, the sales and profits -- and tax liability -- of direct selling companies will be less than they would be without tax withholding.

Admittedly, these indirect costs to the industry and direct salespersons cannot be quantified. But they are real nonetheless, and are likely to fall with a disproportionate incidence between different companies depending on their size, system of sales and financial viability. Moreover, these impacts would be accentuated substantially should tax withholding become the initial step of moving direct salespersons to the status of employees. These indirect costs -- uncommon to other industries and possibly unexpected -- arise because of the economic structure of direct sales companies and the characteristics of direct salespersons.

The costs incurred by the direct selling industry to administer tax withholding can be quantified. There is a tendency to perceive that withholding is a low cost activity because direct selling companies already submit 1099 forms for those commissions and value of prizes above $600 a year. This perception is wrong. On a per-person basis, the cost of withholding may seem low but the real costs of withholding are relatively high in this industry due to several factors: the high annual turnover in the industry (100 percent), the large number of direct salespersons, their low average sales volume, and the high percentage of salespersons involved in a sale-for-resale relationship.

The Treasury has stated that the administrative costs of tax withholding incurred by companies would be largely offset by the financial gains they would reap through the benefit of improved cash flow. For the direct selling industry such gains would be nominal. Existing regulations require that deposits for withholding (both income tax and

FICA) be made by the third banking day following the 7th, 15th, 22nd and last day of each month once the amount withheld is $2,000 or more. Only large corporations with sophisticated cash-flow management can utilize such a short period to their advantage. Under the most optimistic set of assumptions, the financial gains to direct selling companies through improved cash flow would be less than 15 percent of the administrative costs incurred by the industry.

The direct administrative costs of tax withholding have been estimated based on cost analyses undertaken by a variety of direct selling companies. These costs, which are incremental to costs presently incurred for other tax reporting purposes, fall into two categories: start-up costs and continuing annual costs.

The start-up costs of withholding include those associated with the collection, data processing and file creation of forms comparable to W-4s for the approximate 2 million direct sellers who are in active selling status at a given point of time. Within the course of a year, at least one-half or more of these forms will be discarded by the companies as individuals drop out of direct selling or move from one direct selling company to another. The clerical and paper work, computer filing and postage costs are direct and apparent. There are other start-up costs which some companies will experience, depending on their mode of operation, such as those of renegotiating contracts with all active salespersons and designing and implementing new computer systems. These start-up costs are estimated to be $10 million for the industry.

The continuing costs of tax withholding involve the clerical and accounting costs associated with federal paper work: issuing statements comparable to W-2; preparing quarterly 941 and annual 940 statements; filing 501 deposit withholding tax forms and making such deposits. In the direct sales industry, the need to keep records can be particularly burdensome because direct salespersons are intermittent workers -- frequently working only seasonally -- and come into and leave the industry each year in large numbers. Nevertheless, companies would have to maintain the file on every person ever withheld upon for at least three years. Overall, the annual continuing costs of tax withholding are estimated to amount to $70 million for the industry, or the equivalent of 1.0-1.5 percent of net sales. While these estimates are based on projected costs for an activity essentially new to these companies, they nonetheless represent a reasonable approximation of the annual cost burden which the industry will incur.

The continuing cost per salesperson will vary significantly between companies. For some companies the annual incremental administrative cost of direct selling could be less than $5.00 per salesperson, but for most companies the unit costs will be substantially higher. Particularly for small companies with a large number of salespersons operating on a sale-for-resale basis, and for distributors in a multi-level distributorship, the annual costs could be well in excess of $30 per salesperson.

Net Additional Tax Revenues Would Be Nominal

Mr. Lubick states in his testimony that $1 billion in taxes have not been paid by independent contractors and that 60 percent of this (or $600 million) could be captured through the combination of tax withholding and strengthened information reporting. The basis for either of these estimates is yet to be explained. Since the tax compliance rate (ratio of taxes paid to total tax liability) of independent contractors and the total number of independent contractors are both unknown, these estimates can be expected to be little more than rough guesses.

In contrast, it can be demonstrated that the net public revenue benefits to be gained by withholding federal income taxes of direct salespersons would be modest at best. The magnitude of public revenue benefits are expected to be small, principally because the total income tax liability of direct salespersons is itself small. The total tax liability in 1975 for all direct salespersons is estimated to have been only $190 million.

The other and equally relevant factor pointing to the small public revenue gains from application of the proposed changes to direct sellers is that earnings are disproportionately spread over a large number of persons. The great majority of salespersons have little or no tax liability on their direct sales income. This important conclusion is borne out by an analysis of direct sellers' taxable income and tax liability for 1975, based on the Harris survey. The distribution of estimated direct seller net earnings reveals that a very small number of salespersons accounted for a

very large proportion of direct selling income and tax liability; 6 percent of the sellers had almost half the income and 60 percent of the tax liability (see Tables 1 and 3).

The purpose of tax withholding is to improve compliance, both on filing and on accuracy of taxable income reported. For the reasons described previously in this section, the IRS compliance study does not provide the data to estimate directly the amount of tax revenue foregone from those direct salespersons who do not report (file) their earnings from direct sales activities. With the combination of the low average tax liability, the distribution of tax liability by income levels as shown in Table 3, and the recognized correlation generally between increased compliance and increased income, the tax revenue foregone by those salespersons who do not report their earnings should be small. This expectation is borne out by an indirect estimate (derived by combining the income and tax liability data of direct salespersons with estimated tax compliance rates based on data from the IRS study) which indicates that the revenue gain from direct salespersons who do not presently report their earnings would be less than $30 million.[1]

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1. The small additional revenue from tax withholding appears to be applicable to independent contractors generally. The Treasury has stated in its testimony that withholding and strengthened information reporting would raise the tax compliance rate to approximately 90 percent, but estimates based on the IRS study show that the tax compliance rate for independent contractors is already at that level. Moreover, the IRS study shows that additional revenue would come from a very small proportion of independent contractors: two-thirds of the audited workers had no unpaid taxes; in contrast only 14 percent of the audited workers account for 87 percent of the unpaid tax.

Table 3. Direct Sales Industry: Distribution of the Income Tax Liability Burden Among Direct Sellers, 1975

(Percent)

Annual direct sales income classes	Cumulative percent distribution of tax liability	Cumulative percent distribution of salespersons
$0-299..................	1.0	15.7
300-499................	4.0	35.0
500-699................	10.0	56.2
700-999................	12.6	62.1
1,000-1,499............	26.7	74.9
1,500-4,999............	48.1	88.9
5,000-9,999............	60.1	93.6
10,000 and over........	100.0	100.0

Source: Distribution of salespersons by annual direct sales income class prepared by RRNA from the Louis Harris and Associates, Inc. direct sales survey data, op cit. Tax liability from direct sales income computed by RRNA using Internal Revenue Service tax schedules for 1975 as appropriate. Tax liability from direct sales equal to the difference between total household tax liability with direct sales income and total household tax liability without direct sales income. Tax calculation were based on family status (married, single, number of children, etc.) indicated in questionnaires, and assume the maximum allowable standard deduction. A deduction of 16.0 percent was assumed when the maximum allowable standard deduction as a percentage of gross income was found to be less than 16.0 percent.

With respect to the accuracy of income reported, the IRS found in an earlier study that the voluntary compliance rate among direct sellers who file Schedule C tax returns was 89.2 percent of net income, higher than the rate for other self-employed persons filing Schedule C. This compliance rate represents the difference between actual and reported net income due to the combination of several factors -- arithmetical and other errors, underreporting and disagreements between the IRS and direct sellers as to proper deductions. The IRS has estimated an underreporting of taxes by households with direct sellers who file Schedule C to be only $26.8 million; it is important to note that this value reflects underreporting for all income activities of the household and not just income attributed to direct selling, as well as some undisclosed amount for penalties.

This small amount of underreporting is not surprising. Since a large proportion of direct sellers earn low incomes from their direct sales efforts, underreporting, even in the aggregate, would not be large. Moreover, with a large part of direct selling income attributed to a limited number of full-time salespersons, underreporting by such income categories is expected to be insignificant, particularly since IRS compliance analyses demonstrate that underreporting generally declines as incomes increase.

Small though this underreporting is, no more than one-half of this would be realized by the government with tax withholding. Some underreporting would still occur, as indicated by the voluntary compliance rates of 86 to 96 percent for the adjusted gross income of nonbusiness returns

on which taxes are withheld. Whether or not taxes are withheld, arithmetical errors and questionable deductions would still exist, which is no different from the general pattern of audited returns.

Some additional tax revenue -- admittedly difficult to quantify precisely but clearly modest in magnitude -- would be realized from direct salespersons as a result of introducing tax withholding. Even these revenues would be offset in part, however, by two factors. First, corporate taxes from direct selling companies would be less than without tax withholding because of the combination of tax deductions for increased administrative costs of the companies and the expected contraction in sales and profits. Second, the government will incur additional administrative costs with the introduction of tax withholding for independent contractors. While neither of these consequences have been quantified, they are nonetheless real factors that must be considered in determining the net public revenue gains of this proposed tax change.

In summary, the proposal to extend tax withholding to independent contractors should not be adopted. The proposal is based on a tax compliance study which has numerous and serious limitations. Tax withholding would result in high economic costs to the direct selling industry and the loss of income earning opportunities from many individuals with only modest revenue gains to the government. In the case of the direct selling industry the costs are several times greater than the net public revenue gains.

An Alternative Approach

Improvement in the tax compliance of independent contractors (and, indeed, of all self-employed) is a desirable public policy goal. Given this goal and the high net economic costs of tax withholding, alternative approaches to improving compliance should be considered. One distinct alternative is to extend and strengthen the existing information reporting system (by requiring that the payor send a copy of the 1099 form to the payee, increasing the penalties for payors who fail to report 1099s, and encouraging the IRS to utilize more effectively the information reporting system), supplemented by simpler tax return forms and intensified educational efforts. The advantages of this alternative are several. It would be based on an existing system, which the industry knows and already has in place, and thus the incremental administrative costs of changes would be nominal. Because information reporting is already in use, improvements would not impact adversely on the sensitive company-salesperson relationship, thereby avoiding the losses in sales, profits and income earning opportunities for salespersons. Moreover, although much remains to be done, the IRS has made significant progress in utilizing information returns, which it will continue to do whether or not tax withholding is introduced.

The extent to which a strengthened information reporting system will improve tax compliance by independent contractors cannot be determined in advance (though the experience on dividends and interest suggests significant improvements can be achieved). Some improvement in compliance will be accomplished, and with much lower economic

costs than tax withholding. Before introducing a major change in the tax system, improvements to existing procedures would be a more logical step toward improving tax compliance.

With the strengthening of information reporting, the IRS should be encouraged to examine periodically the extent to which tax compliance has improved. This could be done every three to five years with an appropriately structured sample of independent contractors. To provide a base for comparison, consideration should be given to revising the recent IRS study to incorporate the use of information reporting by the employers and individuals in the sample and to analyze the relationship between information reporting and tax compliance.

IV. Direct Salespersons and the Social Security System

Currently under consideration by the Administration is a change in the social security program which would have adverse consequences for the self-employed, and particularly for direct salespersons. This proposal would raise the social security tax rate under the Self-Employment Contributions Act (SECA) to equal the combined employee and employer tax rate under the Federal Insurance Contributions Act (FICA). It is understood that the proposal would allow the self-employed to deduct half of their social security contributions in calculating income taxes, comparable to the tax deduction now permitted employers.

Several arguments are made in support of this proposal. It is argued that the fiscal integrity of the insurance trust funds of the social security system is jeopardized by the current status of direct sellers and other independent contractors as self-employed, and by the existing difference between SECA and FICA tax rates. In addition, the proposed increase in the social security tax rate is based on the claim that independent contractors such as direct sellers receive more than their money's worth in benefits from the social security system as it is now structured and, therefore, they should be obliged in the interest of equity to pay more than they now do. Further, it is maintained that significant amounts of additional contributions to the social security trust funds would be received if the SECA tax rate were raised to equal the joint contribution of FICA.

A study of the available evidence questions the validity of these arguments. It can be demonstrated that the OASDI trust funds are financially secure today and, according to the best actuarial estimates, the 1977 amendments to the Social Security Act ensure that the OASDI trust funds will continue to be solvent until at least the year 2025, if not beyond; that due to the job experience and socioeconomic characteristics of direct sellers, they are liable to pay into the social security system much more than they are likely to receive in benefits; and further, that the gain to the trust funds from the proposed change would be small, particularly when compared to total social security contributions. There are valid reasons for the different social security rates for employees and the self-employed, a differential which has been reaffirmed by the several Advisory Councils on Social Security since 1950. Furthermore, under the 1977 amendments, the SECA rate will increase more rapidly than the FICA rate (2.65 percentage points by 1990 for SECA compared to 1.52 for FICA).

It is not at all clear, as the Treasury has argued, that the difference between the social security rates (total employee-employer FICA rate and the SECA rate) induces employers (or employees) to shift from an employee status to that of self-employed thereby reducing the total contributions to the trust funds. In principle, the difference is too small to induce shifts; for example, in 1980 the difference is only 1.3 percentage points, and in 1985 it will be less than 1 percentage point.[1] Not only is the difference

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1. This difference incorporates reducing the employers' share of FICA by 46 percent to reflect corporate tax deductions.

small but it also means that the net revenue gain (social security contribution and income tax) is also very small. Moreover, there are other factors in the employer-employee relationship which serve to retard shifts from employed status to that of self-employed or independent contractor. Further, there is no evidence that such shifts have occurred; in fact, as shown in Table 2, during 1970-77 the number of self-employed workers increased at only one-third the rate of workers receiving wages and salaries (4.9 percent and 16.0 percent respectively). Thus, the fear that the differential between SECA and combined employee-employer FICA rates will result in lower contributions to the social security trust funds is not warranted.

Most direct sellers receive much less in benefits than they contribute to the social security system. This arises from their social and economic characteristics and patterns of labor force participation. The overwhelming number of direct sellers, 89 percent, work only part-time in direct selling; 81 percent are women; 76 percent are married. As a result, average annual earnings from direct selling are relatively low, especially among women and part-timers. Because the base for social security benefits is calculated by averaging earnings over several decades, the contributions of a number of periods of low earnings when the person works part time or not earning when he is not in the labor force often result in lower average earnings and, thus, little benefits. One-third of all direct sellers do not earn enough from direct selling to be liable for social security taxes since their annual income from direct selling is less than $400.

An actuarial analysis of 13 prototypical direct sellers demonstrates that most direct sellers do not get their money's worth from the social security taxes they pay.[1] The prototypes analyzed earned over $400 in 1975 and hence were liable for SECA taxes. Of the 13 prototypes, 11 were projected to receive less social security benefits than social security taxes paid. For this group, the present value of social security benefits attributed to earnings from direct selling ranges from a low of zero dollars to a high of $11,200 whereas the total SECA taxes paid on direct selling earnings ranged from $1,300 to $25,900. The prototypes projected to receive more social security benefit protection than taxes paid included married men, full time in direct selling and continuing until age 65 ($112,600 versus $81,700), and single women, part time in direct selling with no other job and continuing until age 65 ($32,700 versus $17,500). Thus, under the present social security tax system direct sellers generally contribute more than they receive. Increasing the SECA rate would accentuate this inequity.

The effect of an increased SECA tax burden would be ameliorated only in part by the proposed deduction from income taxes of one-half of the SECA payment. This feature is inequitable and regressive since it favors those self-employed with higher incomes and higher marginal tax rates. The self-employed combine the functions of entrepreneur and worker, and thus, are only in a position to shift the added

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1. The actuarial analysis was undertaken for Robert R. Nathan Associates by a former Chief Actuary of the Social Security Administration. The selection of the 13 prototype direct salespersons, as well as their income, social and work characteristics, was based on the distribution of salespersons as determined by the Louis Harris survey.

tax burden to the extent that they can raise their fees or prices. Among the self-employed are professionals, like lawyers and doctors, who are in a better position to shift the incidence of the tax to their clients than are other self-employed, such as direct sellers.

The absence of an economic rationale for increasing the SECA rate and the adverse effects which this change would have are reinforced by the relatively small amount of additional contributions from the self-employed and direct sellers that are likely to result from increasing SECA taxes to twice the FICA rate. As shown in Table 4, in 1980

Table 4. Estimated Additional Contributions to Social Security by Increasing the SECA Rate to Twice the FICA Rate

	From All Self-Employed		From Direct Salespersons	
	Millions of dollars	Percent of total contributions	Millions of dollars	Percent of total contributions
1980	2,800	2.0	17	0.01
1984	3,800	1.7	24	0.01
1988	5,000	1.6	31	0.01

Source: Office of the Actuary, Social Security Administration; and Robert R. Nathan Associates, Inc.

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about $2.8 billion more would be raised from the self-employed, representing only 2.0 percent of all social security contributions; by 1988, the additional contribution to the trust funds would be $5 billion, but would be equivalent to only 1.6 percent of total contributions. But the self-employed include such upper-income professionals as architects, lawyers and physicians as well as lower-income, blue-collar and service workers, like direct sellers. The potential added contribution from direct sellers is estimated to rise from $36 million in 1980 to $65 million in 1988, averaging annually a mere one-hundredth of one percent of total contributions to the social security trust funds. When the provision for income tax deduction on one-half of the SECA payment is taken into account, the net public revenue gain will be even smaller.

V. Conclusions

The direct selling industry owes its existence and continued growth to the several million independent contractors who sell and distribute its products. Three major issues which affect the role of the independent contractor and the direct selling industry have been examined in this paper. The analyses of these issues demonstrates that there is an on-going need for certainty, by companies and salespersons alike, in the definition of independent contractor status. Tax withholding on independent contractors would require a restructuring of most of the direct selling industry resulting in economic costs which exceed the additional public revenue. Nor is there economic justification for increasing the social security tax rates for the self-employed, particularly for direct salespersons.

Underlying these conclusions are the particular economic characteristics of direct selling companies and the socioeconomic profiles of direct salespersons. Because an independent contractor status encourages direct selling companies to recruit and retain as many direct salespersons as possible, two desirable results are achieved. First, the companies offer work opportunities to persons otherwise denied access to financial opportunities because the marginal costs of adding and retaining such salespersons is low. Second, direct salespersons have the opportunity of being independent business persons. The combination of these factors results in a direct selling labor force which

is predominantly part-time (89 percent), includes an exceptionally large percentage of married women with dependent children without other work (41 percent), and produces a wide disparity in earnings and tax liabilities (6 percent of the direct salespersons account for 50 percent of the income and 60 percent of the tax liability).

These characteristics of direct salespersons are directly relevant to the issues relating to independent contractors. Certainty in the definition of independent contractors will encourage growth and innovation and thereby assure continuation of several million income earning opportunities for direct salespersons. In contrast, a change in status from independent contractor to employee would place such an additional cost burden on direct selling companies that up to two-thirds of direct selling work opportunities would be eliminated. The benefits of certainty in defining the status of independent contractors are not likely to be accompanied by any measurable shift of employees to independent contractor status.

The labor force participation and other economic characteristics of direct salespersons explain why an increase in the SECA contribution to equal twice the FICA rate would further worsen the present discrepancy between the direct seller's benefit entitlements and their contributions to the social security funds. The gain to the trust funds would be small, particularly when compared to total social security contributions. Moreover, the present system of social security rates does not induce persons to shift to self-employed status. In light of these considerations there is no economic rationale to increase the SECA rate.

The proposal that direct selling companies withhold income taxes from their independent contractors has adverse ramifications in this industry far beyond what might normally be expected. If the direct selling companies were to become fiduciary intermediaries between independent contractors and the Internal Revenue Service, direct selling companies and salespersons would be adversely affected with nominal net revenue gains. The industry would face administrative costs of $10 million for start-up and $70 million for the annual continuing costs of tax withholding. Up to half of these costs would be borne by the government because they are tax deductible.

These figures do not take into consideration, however, the financial losses to the industry from the reactions to withholding by present and potentially new independent contractors. These losses would arise through the voluntary terminations of present salespersons and include their own loss of income. In contrast, the total tax liability of direct salespersons, the pronounced distribution of income toward low levels and the voluntary compliance rate of direct sellers indicate that the additional public revenue to be generated by the application of tax withholding to direct sellers will be small.

The proposal to extend tax withholding to independent contractors constitutes a major tax change. Yet, this proposal emanates from a study on tax compliance whose reliability and representativeness must be seriously questioned. Given the doubts about this study and the fact that the economic costs of tax withholding exceed net public revenue gains by several fold, tax withholding should not be extended to independent contractors. Progress toward the public policy goal of improving tax compliance can nonetheless be achieved at substantially lower economic costs through strengthening of information reporting.

SUMMARY

STATEMENT OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE UNITED STATES SENATE

September 17, 1979

The National Association of Independent Insurers recommends to the Subcommittee as follows:

1. That the Subcommittee maintain the historical treatment of commission insurance agents as independent contractors. (Statement pages 3-6.)

2. That the Subcommittee be mindful of the problems created by the Internal Revenue Service's change of position and how the Congress responded. (Statement pages 6-20.)

3. That the Subcommittee accept the Dole proposal, S. 736, as the most sensible and workable solution to the employee-independent contractor classification problem. (Statement pages 21-27.)

4. That the Subcommittee make clear that S. 736 is a safe-harbor bill and that the employment tax status of workers who fail to meet the tests of the Bill will be determined under the common law control test. (Statement pages 27-28.)

5. That the Subcommittee reject the Administration's proposal of withholding on certain self-employed workers as being impracticable and not a solution to the problem posed. (Statement pages 28-33.)

6. That if it is concluded that a prospective solution to this problem cannot be enacted this year, the Subcommittee adopt an extension of the relief provisions of section 530 of the Revenue Act of 1978 for an additional year to permit the enactment of a permanent solution. (Statement pages 34-36.)

STATEMENT OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE UNITED STATES SENATE

September 17, 1979

This statement is submitted by the National Association of Independent Insurers (NAII) in support of S. 736, the "Independent Contractor Tax Status Clarification Act of 1979," which was introduced on March 22, (legislative day, February 22), 1979 by Senator Dole to clarify the standards used for determining whether, for federal employment tax purposes, an individual worker is an independent contractor or an employee.

Background
Concerning NAII

NAII is a voluntary, insurance company trade organization consisting of more than 400 members. Companies, both members and subscribers, now affiliated with the organization total more than 600. Members range from small companies doing business in only one state to one of the largest multi-state writers; from the highly specialized writer of farmers or other consumer groups to the so-called full multiple-line insurer; and from those merchandising their insurance products through the

mails to those using various agency systems. Virtually every state is represented in the membership.

Structure of Agency Relationships in Casualty Insurance Industry

A large portion of the casualty insurance issued in the United States is written by companies which utilize an exclusive agency force. Many companies of this type were organized in order to provide low cost insurance protection in rural communities, and the use of an exclusive agency force was the only effective way to compete with older insurance companies which had established ties to existing general agents. The exclusive agency insurance companies include both mutual and stock companies.

Agents representing the companies are licensed by state insurance departments and must pass a written examination prior to obtaining a license. In general, the agents in question (including both full- and part-time agents) work from their own premises (either home or office), keep their own hours, solicit insurance

business in their own ways, pay their own expenses, and are compensated by commissions. The agents are widely dispersed geographically, and most operate in areas in which the companies have no office or regular employees. District or regional sales managers are available to assist the agents if the agents so request, and, except in limited circumstances, the agents do not represent competing companies. The agency representation can generally be terminated by either party upon specified notice. Most of the companies have been carrying on business in essentially the same way for more than 40 years.

Historical Treatment of Commission Insurance Agents

For purposes of the employment tax provisions of the Internal Revenue Code--the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and Collection of Income Tax at Source on Wages (withholding)--the standard for determining whether a worker is an independent contractor or an employee has, with certain limited statutory exceptions, been the common law test of control. As formulated in the regulations,

a worker is not treated as an employee unless the person for whom he performs services has the right "to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." [Treas. Regs. SS 31.3121(d)-1(c)(2) (FICA); 31.3306(i)-(1)(b) (FUTA); and 31.3401(c)-1(b) (withholding)].

Application of the common-law control test to commission insurance agents, such as those engaged in selling insurance on behalf of the casualty insurance industry, has traditionally resulted in such agents being classified as independent contractors rather than employees. The concurrence by the IRS in this classification is evidenced by the fact that over a period of 30 years commencing in 1937, seven published rulings were issued in which the IRS considered whether commission insurance agents are employees for employment tax purposes. The answer was uniformly in the negative: the IRS consistently ruled that commission insurance agents are not employees; they are independent contractors.

G.C.M. 18705, 1937-2 Cum. Bull. 379; S.S.T. 249, 1938-1 Cum. Bull. 393; Rev. Rul. 54-309, 1954-2 Cum. Bull. 261; Rev. Rul. 54-312, 1954-2 Cum. Bull. 327; Rev. Rul. 59-103, 1959-1 Cum. Bull. 259; Rev. Rul. 69-287, 1969-1 Cum. Bull. 257; Rev. Rul. 69-288, 1969-1 Cum. Bull. 258. The courts likewise accepted this classification. Reserve National Insurance Co. v. United States, 74-1 U.S.T.C. ¶ 9486 (W.D. Okla. 1974); Standard Life & Accident Insurance Co. v. United States, 1975-1 U.S.T.C. ¶ 9352 (W.D. Okla. 1975); and Kelbern M. Simpson 64 T.C. 974 (1975). There are no contrary published rulings or judicial decisions.

Hence, for many years application of the common-law control test afforded insurance companies, commission insurance agents and the IRS a certainty that the relationship between insurance companies and commission insurance agents was that of independent contractors and not employees. All concerned relied on the fact that, with respect to such agents, insurance companies were not required either to withhold and remit income taxes and the employee share of FICA taxes or to pay FUTA taxes and the employer share of FICA taxes. On the contrary, since commission

insurance agents were universally recognized to be independent contractors, they were considered by all to be directly responsible for paying their own income and self-employment taxes.

IRS Changes of Position and Congressional Response

However, commencing in approximately 1970 the IRS, disregarding its own long-established position, began to assert that commission insurance agents were employees. These assertions, which were made without the support of any published authority and without any announced change in position by the IRS, resulted in assessments being proposed or levied against insurance companies, including NAII's members, retroactively, on the ground that commission insurance agents should have been treated as employees for all open years. These assessments represented, in the main, duplication of federal income and self-employment taxes already paid by agents.

Concurrent with its about-face in the treatment of commission insurance agents, the IRS also began asserting for the first time that workers performing services in many other industries were employees rather than inde-

pendent contractors as they had previously been considered. For example, John M. Samuels, Deputy Tax Legislative Counsel, Department of the Treasury, expressly acknowledged that the IRS had changed its position with respect to real estate agents by issuing new revenue rulings recharacterizing the relationship between real estate firms and real estate agents. In Mr. Samuels' words: "They [the new revenue rulings] represented what could fairly be characterized as a change in position with respect to real estate salespeople." (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 121). Similarly, in the case of Aparacor, Inc. v. United States, 556 F.2d 1004 (1977), the United States Court of Claims stated that the Service's attempt to reclassify as employees many thousands of individuals engaged in selling products at retail on a commission basis represented "a radical departure from the traditional common-law concept of an employer-employee relationship."

As a result of these IRS changes in position, confusion suddenly reigned where certainty had been the rule. Congress soon became cognizant of the problem and,

during the deliberations on the Tax Reform Act of 1976, endorsed a statement in the Conference Report urging the IRS not to retroactively apply any changed position in the employment tax area pending completion of a study by the staff of the Joint Committee on Taxation. (Conf. Rep. on H.R. 10612, p. 489)

When it became clear that the IRS was not honoring the Congressional request,* Congress responded by enacting section 530 of the Revenue Act of 1978, which

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*The IRS' cavalier disregard of the Conference Report is illustrated by the Treasury Department's response to a request from Senator Curtis that the Subcommittee on Taxation and Debt Management Generally be provided with "all directions, bulletins, letters, communications, regulations, and so on" that were sent out to all IRS offices and employees instructing them to follow the language of the Conference Report. The Treasury Department indicated that the Congressional request was essentially meaningless and that, accordingly, no such communications had been sent out:

> The conferees on the Tax Reform Act of 1976 urged the Internal Revenue Service not to apply to past tax years any changed position or any newly stated position which is inconsistent with a prior general audit position in this area. The term "general audit position" has little or no meaning. Determinations as to whether workers are employees or independent contractors are made by applying the longstanding common law

was designed to provide interim relief for taxpayers while Congress develops a comprehensive, permanent solution to these controversies. In general, section 530 terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Several "safe havens" were established which, if satisfied, entitle taxpayers to relief. In addition, section 530 allows such taxpayers to continue to treat workers as other than employees through 1979.

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rules on a case-by-case basis, in accordance with the regulations and revenue rulings which were in effect before the Conference Report was issued. However, to the extent that it is possible to identify a "general audit position"--and hence to depart from such a position--such departures are initiated only by the National Office of the Internal Revenue Service. Therefore, it was not necessary for the National Office to instruct field offices not to make such departures. (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 220)

While the relief provided by section 530 did much to assuage the concerns resulting from the uncertainty caused by the IRS changes in position, the solution provided by that section is, by design, only an interim one; the relief extends only through 1979. Therefore, action must be taken by Congress this year.

If action is not taken promptly to provide a permanent solution, the uncertainty and chaos which existed for the past several years will likely return.

Reasons for NAII Members' Concerns--Problems Created By Change of Agents' Employment Tax Status

The problems which will be faced by commission insurance agents, by insurance companies, and by individuals and companies in other affected industries, as a result of uncertainties as to employment tax status are of enormous proportions. None of these problems would be solved by the Administration's proposals to withhold on payments made to independent contractors. These problems include the following:

1. Social and Economic Impact. Commission insurance agents have traditionally and historically viewed themselves, and have been viewed by others, as independent businessmen whose success is attributable to their individual initiative and independent operations. As such, they rightfully take pride in their status as independent entrepreneurs. If Congressional action is not taken to reaffirm that these individuals are indeed independent contractors, long-established social and economic relationships will be threatened, with reverberations reaching far beyond the employment tax area.

2. HR-10 Plans. A large number of commission insurance agents have adopted self-employed persons' pension or profit-sharing plans (HR 10 plans), many of which have been approved by the IRS. If the IRS should again be free to assert that these agents are employees rather than independent contractors, the status of these numerous plans would be placed in doubt. The specter would exist of having these plans retroactively disqualified, since the indi-

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viduals who adopted them might be deemed to be employees and therefore not entitled to maintain HR-10 plans. The result could well be a review of numerous income tax returns of commission insurance agents. If the agents have previously received determinations from the IRS that they are independent contractors and are then reclassified as employees, the plans would be frozen and any future contributions would not be exempt from tax. If the agents had not previously received such determinations, the plans would be disqualified, and all amounts in the plans (previous contributions plus income) would be taxable.

3. Effect on State Income Tax Liability. The federal employment tax classification of workers as employees or independent contractors is paralleled by many state income tax statutes. The rules for withholding of state income taxes generally coincide with federal withholding rules. Moreover, the applicability of certain exclusions and deductions may depend on a worker's employment status (as is the

case with respect to some exclusions and deductions under federal law). Thus, for example, in order to claim business expenses as "above the line" deductions from gross income in determining federal income tax liability, a worker must usually be self-employed. The same rules usually prevail in State systems as well, and the status classification systems are ordinarily the same. Obviously, if the employment tax status of these workers is not clarified by Congress and is subsequently challenged by the IRS, they could face substantial state tax deficiencies.

4. Status of Employees of Agents. Many commission insurance agents have their own employees. Absent Congressional clarification of the standards for differentiating between employees and independent contractors, serious questions will exist as to the status of employees of such agents. The insurance companies have no control over the hiring, firing, compensation, or supervision of agents' employees, who may suddenly be treated as employees of the companies.

5. Company Pension and Profit-Sharing Plans. Qualified pension and profit-sharing plans maintained by insurance companies have not provided for the coverage of agents--in accordance with published pension trust section rulings which flatly state that commission insurance salesmen cannot be covered under a qualified plan. If the employment tax status of commission insurance agents should again be subjected to challenge, these qualified plans may be disqualified for failure to cover the agents in question. This could result in the disallowance of contributions, taxing the income of the plans, and direct injury to thousands of employees who are beneficiaries of the plans. The GAO Report documented that such a result is not purely theoretical. The Report disclosed that in one instance a company had established a generous retirement plan for its office employees. After the IRS determined that the company's independent contractors should have been classified as employees, the company was forced to terminate the office employees' pension plan be-

cause it could not afford to extend the plan to the individuals who had been reclassified as employees. The result was that the reclassified individuals lost their eligibility to establish H.R. 10 plans and the office employees lost their retirement benefits. ["Report to the Joint Committee on Taxation, Congress of the United States, by the Comptroller General of the United States--Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," pp. 15-16 (November 21, 1977) (hereinafter referred to as the "1977 GAO Report")].

6. Penalizing Effect of Changes in Status. Should the IRS again be free to throw down the gauntlet on this issue, insurance companies would be faced with substantial burdens in the operation of their businesses even if they should ultimately prevail in establishing that their commission agents are independent contractors. Such challenges would give rise to contingent liabilities which ordinarily must be noted for financial statement purposes, with

the result that the ability to raise capital, borrow money, take advantage of business opportunities, and even to sell insurance might be impaired. Additionally, the companies might be subjected to tax liens for the unpaid, disputed tax liabilities, or to the substantial costs of posting bonds or collateral.

7. Impracticability of Withholding. If the IRS is permitted to resume its attempts to change the classification of commission insurance agents from independent contractors to employees, significant problems concerning withholding of income taxes and the "employee's" share of FICA taxes, as well as the company's liability for the "employer's" share of FICA taxes, would result. Commissions paid to insurance agents constitute gross income. From these the agents must deduct business expenses, which could include such things as wages of his employees, office expenses, and automobile expenses. The insurance company has no way of determining the amount of these expenses. Obviously, such gross commissions cannot be equated with "wages" in any fair interpretation of the term.

NAII understands that this problem is exacerbated in other industries where the individuals whose employment tax status is in question purchase goods from their putative "employer" company at a wholesale price and sell them at retail. In these instances, not only does the company not know the amount of the individual's income after deduction of business expenses, but it also often does not know the amount of the individual's gross income. Moreover, because no payments are made by the company to the individual, there is nothing from which to withhold employment taxes.

Withholding on gross compensation, whether in the form of commissions to insurance agents or in some other form, can also have a significant adverse impact on the individual workers, since they could well face problems of overwithholding of income tax. Even if such individuals were extended the right to claim additional personal exemptions on their employee withholding statements to reduce the amount withheld from their gross income, it

might be difficult, if not impossible, to estimate the amount of future commissions and expenses, and thus the number of exemptions to claim.

8. Effects on Competitive Relationships. Absent Congressional clarification of the standards for determining the employment tax status of workers, companies subjected to IRS challenge as to the employment tax status of their commission insurance agents may be placed at a competitive disadvantage with respect to other insurance companies. The example posited by the Staff of the Joint Committee on Taxation is illustrative:

> [A]ssume that the A company and the B company are substantially similar enterprises, and that A's workers are treated as independent contractors, while B's workers (who perform functions identical to those of A's workers) are treated as employees. (This difference in treatment could be explained either in terms of each business' interpretation of the common law test, or by virtue of a reclassification of workers by the Service pursuant to an audit.) In such an instance, the B company must withhold income taxes from its workers' compensation, and pay an employer's share of employment taxes.

> Moreover, B must comply with the various obligations pertaining to recording and depositing such funds, in addition to furnishing each employee with an annual statement as to that employee's taxes. On the other hand, the A company simply must record the amounts paid to its workers in such a manner that A can substantiate the payments for tax purposes generally, and determine whether the aggregate annual payments to any worker necessitates the filing of information returns. While A's failure to satisfy the latter obligation could result in a $1 penalty per covered payment, B's failure to comply with its obligations could result in substantial penalties. Thus, because of the significantly different obligations of each company, A might have a competitive advantage over B. ["Issues in the Classification of Individuals as Employees or Independent Contractors: A Report Prepared by the Staff of the Joint Committee on Taxation," p. 21 (February 28, 1979)].

Notably, even if the expanded withholding proposals advocated by the Administration were to be enacted into law, the question of employment tax status would still remain unanswered. Accordingly, the risks of companies being subjected to competitive disadvantages as a result of IRS challenges to the status of commission agents would remain.

S. 736 Provides
a Sensible, Workable Solution

If problems such as these are to be avoided, Congress must take action to provide definitive standards for determining the employment status of workers in industries, such as the insurance industry, where the IRS created havoc by reclassifying as employees workers who have long been recognized by all to be independent contractors. We believe that S. 736 will accomplish this end by providing safe-harbor standards which will preserve the status of workers who have historically been recognized to be independent contractors. If the five tests of the Bill are satisfied, the worker will be treated as an independent contractor. On the other hand, if the five tests of the Bill are not satisfied, the worker will not automatically be deemed to be an employee. In such cases, the common law test will control.

The safe-harbor approach of the Bill recognizes, as did the 1977 GAO Report, that it is not feasible to impose a rule that will clearly establish the status of all workers. Any bill attempting to do that would likely

produce arbitrary results which would impose unnecessary hardships on both workers and those for whom services are performed. The harm caused by such an approach could be as bad as that caused by the Service's recent changes in position. No such broad-brush approach is necessary.

What is necessary is to restore to workers and companies in the industries affected by the IRS reclassification program the certainty as to employment status which has long existed and upon which those individuals and companies have relied in establishing their relationships and planning their affairs.

S. 736 will accomplish this result. The five-factor test which it adopts as a precondition to coming within the "safe harbor" will restore to this confused area of the tax law the certainty which is so vital. It will permit both individual workers and companies in the affected industries to know with a high degree of assurance both the nature of their relationships and their respective employment tax responsibilities. At the same

time, the Government will be provided the information necessary to insure compliance with the tax laws.

Thus, for example, under the provisions of this Bill commission insurance agents and the companies for which they sell insurance will have restored to them the certainty that theirs is an independent contractor relationship. They will be able to meet the Bill's tests which go to the substance of the relationship without making changes in the way they have traditionally structured their relationships and conducted their businesses.

- Control of hours. Commission insurance agents have historically controlled both the number of hours they spend selling insurance and the scheduling of those hours.

- Place of business. While many commission insurance agents actually engage in selling their product at the customer's residence or office, they nonetheless operate out of their own homes or offices and thus maintain their own principal places of business.

- Income fluctuation or investment. By the very nature of being remunerated on a commission basis, commission insurance agents have no assurance that their income will bear any relation to the amount of time devoted to selling insurance. Rather, commission insurance agents assume the risk of fluctuations in income based on their own degrees of success in selling insurance. Moreover, insurance agents who receive override commissions based on the sales of others with whom they work jointly or whose activities they oversee likewise have no assurance that their income will bear any relation to the amount of time they spend in their endeavors; they bear the risk of significant income fluctuation.

Since many commission insurance agents maintain offices, they would also meet the alternative test of the bill--substantial investment in assets.

By virtue of complying with these tests, which go to the substance of the relationship, commission insurance agents and insurance companies will again be able to

operate with the assurance that their relationship is, as it has always been, not one of employment, but of independent contractors. In short, the Bill will codify what has always been understood. At the same time, the tests set forth in the Bill should not allow parties artificially to assume the posture of independent contractors, since each of the tests is by its very nature inconsistent with an employer-employee relationship. One who sets his own hours of work, maintains his own place of business, and whose income is not directly tied to the amount of time spent working or who has a substantial investment in the assets of the business is not an employee. And one who is an employee will not be able to meet these tests. Accordingly, the Bill will not result in individuals and companies which have traditionally operated in an employment relationship being able to escape their employment tax responsibilities.

At the same time, the Bill requires that in order to come within its safe harbors, the worker must perform services pursuant to a written contract which informs the worker of his independent contractor status.

In addition, the worker must be informed either in the contract or at the time it is executed of the tax obligations imposed on him as an independent contractor. Moreover, the Bill requires that in order to gain admission to its safe harbors, the person for whom services are performed must file all requisite information returns, that is, Form 1099s.

The Bill thereby ensures that those who seek to come within its safe harbors will know what their status is and what their resulting tax responsibilities are. Furthermore, by conditioning admission to the safe harbor on a requirement that the person for whom services are performed file all required information returns, the Bill ensures that the Government will have the appropriate tools to enforce compliance with the tax laws.

Accordingly, the concerns expressed by the Department of the Treasury and the Internal Revenue Service in a joint letter appended to the 1977 GAO Report and in statements before committees of the Congress are completely answered by the Bill. Those concerns were that

a change in the law might increase the number of self-employed persons, that self-employed individuals allegedly have a low compliance rate in reporting income earned, and that consequently such a change might result in lost tax revenue. NAII seriously doubts the validity of these concerns, at least with respect to the casualty insurance industry, since studies have shown an extremely high level of compliance by insurance agents associated with member companies of NAII. Indeed, even the limited compliance studies conducted by the Internal Revenue Service show that 98.3 percent of compensation received by casualty insurance agents is reported. (Statement of Mr. Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy), before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, June 20, 1979). However, it is readily apparent that the matters over which Treasury and the Internal Revenue Service have expressed concern will not come about under S. 736, since the tests which have been incorporated into the Bill cannot be met by an individual who is properly classified as an employee, and since the Internal Revenue Service

will be provided with information returns which will enable it to enforce compliance.

S. 736 Should Be
Amended to Make Clear
That It Is a Safe-Harbor Bill

As already indicated in this statement, NAII believes it is clear that S. 736 is a safe harbor Bill and that where the five requirements of the Bill are not met, reference will be made to the common law to determine the worker's employment tax status. However, in order that there be no room for doubt in this regard, NAII suggests to the subcommittee that the Bill be amended to provide that if all the requirements of subsection (b) are not met with respect to any service, nothing in the section shall be construed to infer that the service is performed by an employee or that the person for whom the service is performed is an employer, and any determination of such an issue shall be made as if the section had not been enacted.

Inclusion of such a provision in S. 736 would leave no room for doubt that the Bill is intended to

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provide a safe-harbor to those whose long-standing treatment as independent contractors has recently been challenged as a result of the Internal Revenue Service's changes in position. However, the Bill does not make individuals employees if they are independent contractors under the common law.

Administration's Withholding Proposals Provide No Solution

Faced with taxpayer and Congressional concern caused by the countless problems resulting from the Internal Revenue Service's distorted applications of the common law control test, the Administration has sought to sidestep the issue by proposing an expanded form of withholding which, they contend, will "take the pressure off" that test. Under the Administration's proposal, payments made in the course of a trade or business for services provided by an independent contractor would be subject to withholding at a flat rate of 10 percent. Individuals who work for five or more persons or who would be overwithheld would be permitted to elect out of the system. The Administration proposes further that in

lieu of the payor's liability under present law for income and FICA taxes which should have been withheld, payors would be liable for a penalty tax of 10 percent of the amount of wages not withheld upon. This penalty tax would be abated if it were reasonable for the payor to conclude that a worker was an independent contractor, and the payor withheld a flat rate of 10 percent from the worker's compensation (or was excused from withholding because the worker elected out of the system).

This proposal provides no solution at all. On the contrary, it leaves totally unanswered the basic issue which has given rise to the entire problem--finding workable standards for determining whether, for Federal employment tax purposes, an individual worker is an independent contractor or employee, which the IRS and Treasury have previously requested before this very Committee.

Given Mr. Lubick's repeated statements that the common law test provides an inadequate method for resolving employment tax status questions, NAII finds the Treasury's utter failure to address the issue to be astonishing.

Under the Administration's proposal, payors and individual workers would remain in the quagmire which now exists under the common law standard. In view of the IRS' recognized history of "radical departures from the traditionaly common-law concept of an employer-employee relationship," how would payors know with certainty under this proposal whether they have a liability for FUTA tax with respect to individual workers? How would payors determine with certainty whether they have a liability for the employer's share of FICA taxes? Indeed, in the absence of definitive standards, how would a payor even know whether it is reasonable to conclude that a worker is an independent contractor, thereby assuring that the 10 percent penalty proposed by the Administration would be assessed? The Administration's proposal offers no solution to any of these questions. Moreover, individual workers are left in the same quandry. They have no sound basis for determining whether their remuneration is subject to withholding or to self-employment taxes. Similarly, their HR-10 plans and pension and profit-sharing plans set up by companies for which they perform services remain

subject to disqualification should the IRS determine under its reading of the common-law control test, that they are employees and not independent contractors.

In short, the expanded withholding proposal suggested by the Administration does nothing to end the problems of uncertainty about the definitions of "employee" and "independent contractor." Under this proposal, both payors and individual workers are left with no clear standards to assure them that they are acting within the law.

The Supreme Court has expressly held that especially in this area of the tax law, where employers are required to act as collection agents for the Government, the "obligation to withhold [must] be precise and not speculative." Central Illinois Public Service Co. v. United States, 98 S. Ct. 917 (1978). The Administration's proposal falls far short of this admonition.

The Administration's proposal for expanded withholding is unwarranted for additional reasons. This is especially true with respect to the insurance industry.

The proposal is expressly based on the assumption that a large percentage of independent contractors do not report their earnings. NAII seriously questions the validity of the survey upon which this assumption is based. But significantly, even that survey acknowledges that 98.3 percent of the compensation received by casualty insurance agents is properly reported. Given this concededly high level of compliance, there is simply no basis for imposing on insurance companies and their agents the substantial costs which would be incurred in meeting the demands of the IRS to do its job--collect taxes.

Moreover, under the Administration's proposal, large classes of individuals would be exempted from the withholding requirement because they perform services for five or more payors or will otherwise be overwithheld on. The purpose of these exemptions is laudatory. However, by placing large classes of independent contractors outside the system, the exemptions would defeat the Administration's stated goal. For example, independent contractors in the real estate construction and home improvement industries quite frequently perform services for several

payors in the course of a year; they would thus be entitled to opt out of the system. According to the IRS's compliance study (and assuming arguendo that its results are valid), individuals in those industries have among the highest rates of noncompliance. Similarly, it would seem that individuals in the logging and trucking industries would lawfully and reasonably qualify for exemption under the "overwithholding" exception, and yet according to the IRS's study, those industries, too, have relatively high levels of noncompliance.

This is not to suggest that the exemptions be excised from the Administration's proposal. Indeed, without such exemptions, it seems likely that even the Administration would concede a withholding system would be grossly unfair and inequitable. The point is simply this: the Administration's proposal would not accomplish its goals. Congress simply should not rush in, willy-nilly, to impose withholding, which would undeniably be expensive and burdensome, where there is no assurance that it would produce any better results than a less expensive, less burdensome alternative. That alternative, as S. 736

proposes, is strengthened information reporting. It should not be assumed that the best way, the only way, to solve the compliance problem (assuming it exists) is to enact the Administration's ambitious withholding proposal. This is especially true in light of the high compliance rates that were found in those industries, such as the insurance industry, that have voluntarily assumed a greater information reporting duty than that imposed by law.

Conclusion

NAII believes that S. 736 will adequately protect the interests of all concerned. Those whose long-standing status as independent contractors has recently been challenged by the Service's reclassification program will receive the necessary reaffirmation that their independent contractor relationships will not be changed. Those who are not entitled to independent contractor status will not be able to utilize the provisions of this Bill to assume that status. And the Government will have the tools and information necessary to ensure that those who seek the safe harbors of the Bill are complying with

their obligations under pertinent provisions of the tax laws.

NAII believes this Bill provides the comprehensive solution which the Congress indicated it was seeking when it enacted the interim relief provision in the Revenue Act of 1978, and we urge the Subcommittee to recommend its enactment.

NAII recognizes that there may not be sufficient time remaining in the present session of Congress to permit the enactment of a Bill, such as S. 736, which provides a permanent, comprehensive solution to this most difficult problem, as was intended at the time section 530 of the Revenue Act of 1978 was enacted. The relief granted by section 530 extends only though December 31, 1979. Therefore, in the absence of Congressional action, taxpayers would face the prospect of again being subjected to the chaos and IRS harrassment which existed prior to the enactment of section 530. Again they would face the possibility of reporting substantial contingent tax liabilities on the public financial statements. Again company

pension plans would be subject to disqualification. Again the status of independent contractors' H.R. 10 plans would be called into question. Again the ability of many small businesses to continue in existence would be threatened.

It is, therefore, imperative that action be taken this year by the Congress to insure that such a relapse does not occur. If the Subcommittee concludes that it is not feasible to provide a complete solution to the problem this year, NAII strongly urges that the relief provisions of section 530 be extended for one year, through December 31, 1980, to assure that taxpayers and the IRS will be able to know with certainty the rules of the game until a definitive solution is forthcoming. Such an extension of section 530 can be accomplished simply by changing the date "January 1, 1980" to "January 1, 1981" in each of the three instances where it appears in that section--section 530(a)(1)(A); Section 530(a)(3); and section 530(b). By thus extending the relief provisions of section 530 in the absence of a permanent, comprehensive solution, all concerned will know the status of workers, and their resultant obligations, under the employment tax laws.

TESTIMONY OF

THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

PRESENTED BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

SEPTEMBER 17, 1979

ON THE TOPIC OF

THE STATUS OF INDEPENDENT CONTRACTORS FOR TAX PURPOSES

AGC is:

* More than 30,000 firms including 8,000 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;
* 113 chapters nationwide;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities.

~~Mr. Chairman and members of the committee, my name is~~

~~I am here representing the Associated General Contractors of America. Primarily, I am here to speak in behalf of the small businessman in construction, requesting amendments to S. 736.~~

Mr. Chairman, the purpose of S. 736 is to clarify the status for tax purposes of as many payees as possible so that wasteful and unnecessary litigation and harassment will be eliminated in the future. We also believe a necessary and proper objective of these deliberations would be to provide consistency among the various federal agencies in their definitions of who is and who is not an independent contractor. That is, the law should permit an individual to anticipate with some reasonable certainty whether or not he qualifies as an independent contractor regardless of which governmental agency he is confronting.

In fact, Chief Judge Bazelon of the United States Court of Appeals in the District of Columbia, in a 1974 case complained: "On consideration of that issue (whether owner-operators are independent contractors or employees), I find myself in a maze of precedents with few standards for decision discernible."

To our knowledge Chief Judge Bazelon's complaints have not received attention.

We do not believe the Congress has provided the courts with helpful confirmation concerning the economic reality test that would enable the courts to easily and consistently determine whether small businessmen who own and operate their own equipment, or, under lease to carriers,

are employees or independent contractors.

This bill provides Congress with an excellent opportunity to do just that, basing the criteria on two leading tax decisions: U.S. v. Mutual Trucking Co.[1], and the decision in two cases considered jointly; U.S. v. Silk and Collector of Internal Revenue v. Greyvan Lines.[2]

These hearings also provide Congress with an opportunity to protect the common law generally in addition to the economic reality and control tests, and to promote private, free enterprise by precluding regulations that would prevent the entrepreneurial system from operating.

During the course of our testimony, we will address each of these objectives in discussing the Dole bill section by section and will offer what we hope to be useful amendments that will assist the Congress in finding a permanent solution to this difficult and complex area of the law.

We appreciate the concern of the Administration, IRS and Congress that everyone pay his fair share of taxes. We also appreciate their concern, along with that of Mr. Lawrence Thompson of the Department of Health, Education and Welfare, that the integrity of our social security system be preserved and that potentially needy persons not be eliminated from the program. However, we are deeply concerned about the content, thrust and reasoning of some of the testimony that has been given in this matter. You have heard from those who help pass laws to collect taxes, those who administer the collection of these taxes, and those who spend the taxes collected. We want to speak on behalf of small businessmen who hopefully will expand and provide the jobs that make payment of these taxes possible.

We want to speak on behalf of the entrepreneurial business people, be they large or small, who are working under very difficult circumstances to produce the goods and services the public wants at a price the public can afford, and at a profit that will enable the entrepreneurs to pay the taxes Washington wants and still to stay in business.

Mr. Chairman, the Associated General Contractors of America views with deep concern the non-compliance statistics released by IRS and the General Accounting Office. AGC has long been on record before congressional committees as advocating and supporting those legislative proposals which extend equity, economy, and efficiency in government.

Senator Bellmon, in his September 10, 1979 speech on the Senate floor, said in regard to the non-compliance statistics: "This clearly suggests that withholding is the most efficient method for eliminating the problem of noncompliance with tax laws. This is the solution I propose in S. 1565."

In his June 20th statement before the Select Revenue Sub-committee of the House Ways & Means Committee, Sec'y. Lubick said that the IRS' compliance study "demonstrates that there is widespread non-compliance by independent contractors." Also, the General Accounting Office study presented to the House stated some 5 million wage-earners, 17% of whom are self-employed, avoided payments of $2 billion in income taxes.

We note that Sec'y. Lubick went on to emphasize "a further finding was that non-compliance rates do not have much to do with the industry classification of the worker." Therefore, with all due

respect to Sen. Bellmon and others we believe, Mr. Chairman, that 83% of the problem and possibly more is outside the area of the independent contractor, and is widespread throughout our society.

We must, then, respectfully suggest that this problem is of such magnitude as to require that it be addressed in separate legislation after appropriate studies. The broad tax evasion question should not be confused with the purpose of these hearings - to clarify the status of the independent contractor. And the public should not be deceived by suggestions that the problem will be solved by a withholding tax on independent contractors.

To amplify this suggestion, we again turn to the GAO study. This study was critical of IRS enforcement policies, saying "IRS has not taken the action needed to get a good understanding of how many non-filers exist, who they are, why they fail to file, and what action will prompt their compliance." We assume this same lack of information exists in all industries in the private sector.

If the Chairman desires, we can insert for the record an exchange of correspondence between AGC and IRS showing that we asked for this data in the construction industry. IRS can not give us that data because it is private tax information. As a result, we cannot give you a profile of the non-filer in the construction industry.

We noted that the GAO study recommended that "IRS needs to be more systematic and vigorous in detecting and pursuing non-filers," and that Congress consider allocating more funds for detecting evaders. IRS obviously wants to lay this problem on the doorstep of the independent contractor and the payor.

This subcommittee and the Congress must give serious consideration to the GAO recommendations. I do not see any justification for placing these costs and administrative burdens on the independent contractor. And, again, this substantiates the need for special hearings on this matter, which affects the entire structure of the U.S. voluntary tax system.

Mr. Chairman, we are up to our eyeballs in rules, regulations, directives, procedures, inspections, audits and paperwork from an evergrowing horde of agencies of the federal government. An article in the August 6, 1979 issue of U.S. News & World Report stated: "latest estimate from the Office of Management and Budget on the time Americans will spend on all federal forms this year: 786 million hours or an average of 3½ hours per person. Filling out Internal Revenue Service forms will take 577 million hours." The business community must pass on to the consumer this tremendous economic loss of productivity through higher prices for fewer goods and services.

Sec'y. Lubick of the Treasury Department, in his statement to the House Subcommittee, said he was fearful that attempts by the IRS to collect from independent contractors through regular tax collections would be an administrative burden upon the IRS of millions of letters, telephone calls, and visits which would be regarded as harassment of the "little people." In another instance he stated that the lost revenue from the present system is estimated at one billion dollars. Even if this estimate is correct, we can guarantee you that full compliance by the business community with the proposed withholding requirements, the record keeping, and the subsequent follow-up by the IRS would cost the economy of this country more than one billion dollars in lost productivity, and most certainly will be regarded as

harassment by the business community and the "little people." What we need in order to produce more goods and services is less paperwork requirements, especially for the small businessman. Increased regulation sounds harmless when one agency considers only its own requirements, but I assure you that the cumulative effect of all governmental requirements is a national disaster of major proportions.

Sec'y. Lubick also stated at the House hearing that the IRS study showed that 47% of the independent contractors reported none of the compensation in question for tax purposes. I want to point out that Sec'y. Lubick also admitted that the study showed that only 20-25% of the total income from all independent contractors was unreported. He also admitted that of the 47% of the people who did not report, most came from the low income brackets.

As Senator Bellmon pointed out in his speech, the latest IRS study "estimates that $75 to $100 billion of income from legal sources was not reported to the Treasury in 1976. Of this amount, $7 to $14 billion was due to nonreporting of interest and dividend income."

Senator Bellmon goes on to say: "However, the Treasury Department proposes only to extend information reporting to interest derived from certain money market and other debt instruments to reduce underreporting." Since when has the government become so interested in counterproductive, withholding paperwork to extract the last dollar from the low income group?

Sec'y. Lubick proposes that, even if it were reasonable for the payor to treat the worker as an independent contractor, and even if the worker had signed a statement electing out of the system, the payor would still be liable for "his share" of FICA and

FUTA taxes without any attempt by the IRS to determine whether the worker had paid his SECA taxes. Also, Sec'y. Lubick urges that any criteria adopted for determining whether a person is an employee or an independent contractor should "provide certainty by erring only on the side of classifying workers as subject to graduated withholding." It seems the IRS wishes to collect the most taxes possible in the easiest way possible for the government, with little regard for the administrative burden placed on the productive segment of our society. This, coupled with the apparent goal of eventually replacing the small independent, free enterprise entrepreneurs with more placid, more regimented and less productive employees, is an insidious infringement on our cherished freedoms and a drag on our productivity.

Instead of discouraging the proliferation of small independent contractors we should do everything in our power to encourage growth in their number, even to the extent of giving tax incentives. For many present-day businessmen, their status as independent contractors provided the first step in establishing their own business enterprises. In some instances it was full time work, in others it was part time, extra work, at nights and on weekends and holidays. These are fiercely independent people who are trying to get ahead on their own. And we might point out that many of them are members of minority groups that are being encouraged to start their own businesses by other governmental agencies. They are performing valuable services and fulfilling vital needs that result in substantial economic benefits for our economy, far beyond the proposed 10% tax to be withheld from the 23.6% of gross income from all independent contractors who are not now reporting according to Sec'y. Lubick. The 10% tax on this

gross income, even if actually owed to and collected by the federal treasury, is a pittance compared to the administrative and economic costs to the business community and to the consumers that would result if the independent contractor status was serioudly eroded. Also, many of these independent contractors would simply raise their prices 10% if 10% was withheld at the source, again contributing to increased cost to the consumer and adding to inflation.

Sec'y. Lubick said that "in effect, the employee pays the employer's share of the payroll tax in the form of lower gross wages." This simply is not so in the construction industry. In the construction industry the contractor figures each of his elements of cost and arrives at a total cost. To this total cost he adds a hoped-for profit in order to arrive at his bid to the consumer. His portion of the social security tax plus that of the employee is included in the total cost and is paid by the consumer in increased contract price for the construction he purchases. In fact, when social security taxes are raised substantially, many employers increase their workers' pay so that the take-home pay is not reduced. The consumer also pays this added cost. This is pure and simple economics and nowhere is it more obvious than in the construction industry.

There seems to be a general agreement in the private sector that independent contractors should be distinguished from employees and exempted from federal tax withholding requirements. The problem exists in defining an independent contractor.

Section 3508 (b) of the Dole proposal is a fair and reasoned refinement of the common law control test. Therefore it justly qualifies for what has been referred to as a "safe harbor." However, in the construction industry there are several ways one or more of

the five points will not be met and yet tax law, under the economic reality test, upholds, for example, owner operators as independent contractors.

AGC therefore very strongly recommends the inclusion of subsection (c) found in H.R. 5266[3] introduced by Congressman Phil Crane, a member of the House Ways and Means Committee and former ranking member of that body's task force on the independent contractor.

This "safe harbor" is primarily based on the aforementioned Mutual Trucking and Greyvan cases, giving this provision, we think, equal standing under tax law. In the Mutual Trucking case it was held that control factors are not conclusive when the payor controls the work only for the results to be accomplished.

In Greyvan, the economic reality test received further expansion under the common law. On the facts, the Supreme Court concluded, and I quote: "Where the arrangements leave the driver-owners so much responsibility for investment and management..." they must be held to be independent contractors. Thus, under the economic reality test or the "investment and management" test, a person who owned his own tractor and leased it to a trucking company in exchange for a percentage of the revenue obtained for hauling on orders solicited and obtained by the trucking company was deemed an entrepreneur, not an employee.

In addition, other courts reviewing owner operator litigation other than tax cases have also upheld this principle.
As we emphasized at the beginning, an individual should know if he qualifies as an independent contractor regardless of the agency he is confronting. Since the National Labor Relations Board and the courts under the Taft-Hartley Act attempt to implement the common law

definition of independent contractor, and the IRS attempts to accomplish the same purpose, this subsection (c) will be of special significance. It will show that the Congress will not permit tax law as defined by the IRS to conflict with or replace the common law regarding the independent contractors as viewed by other agencies and the courts.

It is our understanding that the National Labor Relations Board now accepts the "investment and management" test. In his remarks at the American Bar Association National Institute, Washington, D.C., April 27, 1979, Edward B. Miller, managing partner in Pope, Ballard, Shepard & Fowle, Chicago, and former chairman of the National Labor Relations Board said, "The board has also rather recently accepted the findings of the ninth circuit in a series of cases involving Associated General Contractors of California, wherein the court had found that the board had erred in finding certain dump truck operators to be employees, again because it had failed to apply the common law tests (564 F.2D 271 (1977), 239 NLRB No. 100 (December 11, 1978)."[4]

This court's articulation of a bona fide owner-operator which we call to your attention appears on page 16,832 in the case cited as 82 Labor Cases at 10215, a copy of which is attached to this testimony. In this case, the court referred to the "investment and management test as the "total factual context." This emphasizes the need, as Judge Bazelon complained, for Congress to clarify the "maze of precedents." Congress can do that, we believe, in these two "safe harbors."

You may ask, why can't this be done in one "safe harbor?" Let us examine the five requirements of subsection (b) of the Dole bill.

As to requirement #1, control of hours worked, many very independent contractors who own their own dump trucks, welding rigs, backhoes, draglines, etc., have their hours of work dictated for a specific contract by the general contractor in accordance with the needs of the construction program and probably would not be covered by the Dole proposal for that reason.

And by no stretch of the imagination could an owner operator on a construction site do substantially all of the scheduling of the hours worked. On some large projects, a contractor will have as many as 500 trucks dumping and/or removing material. Most of those owner operators would not know who the others are or where they are from and could not even attempt to schedule their arrivals and departures as the contractor needs them to obtain certain results.

We also see the principle in the Mutual Trucking case -- that the payor can control and direct an independent contractor (owner-operator) as to the result to be accomplished by the work -- is in conflict with this requirement.

Therefore, after just the first requirement we can see that the criteria for the two "safe harbors" are apparently incompatible and probably cannot be drafted into one subsection.

As to requirement #2, place of business, owner operators of trucks usually have over night vehicle parking problems and normally find rent-free parking accommodations on the construction site. That again could result in their disqualification under the Dole proposal.

As to the requirement #3(b), income fluctuations, many of this same type of independent contractors are paid by the hour or partially by the hour for the hours they and their equipment work. They usually

are responsible for their own fuel oil and maintenance, etc., and suffer loss of compensation during periods of breakdown or other work stoppage. But their tax status under the ~~Gephardt~~ DOLE proposal probably would be challenged by the IRS because all of their compensation is not directly related to output. The more realistic line of demarcation would be whether or not the earnings are partially attributable to the equipment owned and operated by the individual, as distinguished from earnings attributable solely to his manual contributions. That line of demarcation differs from that in the Dole proposal. However, apparently an owner operator would qualify under #3(a).

As to requirement #4, written contract, most small construction contracts are verbal and are administered by the job foreman, who is a good craftsman but is often lacking in paper ability. You would be surprised at how very difficult it is just to obtain a proper W-2 form from the field. We can see that the necessity of obtaining a signed contract before performance would be a real problem, so that requirement would not be met in many instances.

As to requirement #5, filing of required return, there would be many instances where the payor would fail to file information returns required for such services under code section 6041(a), either through administrative oversight or through lack of proper knowledge of all the ramifications of the law. For that reason, AGC supports the two provisions in the Crane bill. First, Sec. 3508(c)(7), that unless the failure to file is willful or intentional, the individual's status is not affected.

Second, and most important, Crane's Section 4, that instructs IRS to conduct a four year study of this legislation's impact

on compliance. We feel this eliminates the need to include withholding at this time and gives IRS time to prove that noncompliance among the self employed can only be solved by withholding, if that is in fact the case.

As Senator Bellmon said, the recent disclosure "suggests that withholding is the most efficient method for eliminating the problem of noncompliance," but he didn't say the disclosure proved it.

Before the Congress enacts a requirement that could force some small businessmen to close shop, it would seem prudent to require a very detailed and reliable study, even if it requires an additional appropriation to IRS.

We do suggest that report language indicate that IRS should be instructed to develop a new, shorter, more efficient reporting form to be used in connection with the study, perhaps along the lines of that used for reporting interest income.

However inappropriate the Dole points would be to owner operators, they would appear to be important to the common law control test and should be enacted into law. However, AGC emphasizes that the Congress, in order to be completely responsible in this matter, must give proper attention to the tax law regarding the economic reality test.

In this regard, I take this opportunity to call your attention to the following figures, as a brief comparsion, received from the Bureau of Labor Statistics:

Total Males Employed, 1978	55,490,000
Total Males Self-Employed, 1978	
Non-Agriculture	4,529,000
Agriculture	1,455,000
Total Males Employed in Construction, 1978	5,630,000
Total Males Self-Employed in Constr., 1978	1,045,000
Total Employed in Trucking Service, 1978	1,343,000
Total Self-Employed in Trucking Service, 1978	176,000
Total Employed in Insurance, 1978	1,776,000
Total Self-Employed in Insurance, 1978	106,000
Total Employed in Real Estate, 1978	1,478,000
Total Self-Employed in Real Estate, 1978	258,000

Most of the self-employed (independent contractors) in construction and trucking are owner-operators. So it appears that the owner-operator group is larger than many of the independent contractor groups that are now included in the Gephardt/Dole "safe harbor." In addition, 57,000 of the self-employed in the construction category are non-white payees.

So we are not only discussing the common law, economic reality test, but also large numbers of independent contractors and large numbers of minority payees. According to Overdrive magazine (of Delray, California,) there are approximately one-quarter million truck owner operators in the United States in just the large construction and trucking areas alone. So we can assume that there are many more non-truck owner operators in construction and truck owner operators in the very small construction and trucking service industries. We would also have to include owner operators in all other fields so the numbers would be quite significant. Overdrive estimated that 20% of these owner operators are non-white.

In fact, the route provided to owner operators of equipment is one of the most common ways in which small businessmen, including minority group members, have been able to make successful entrances

into the construction industry. Several past presidents of The Associated General Contractors began their careers in the construction contracting business by serving as owner-operators of pieces of equipment.

The recognition of bona fide owner operators in the construction industry would be a very appropriate move for the federal government, in view of the high profile which Congress has given to minority business enterprise (MBE) in the construction industry. It is no secret that The Associated General Contractors has opposed the MBE law in litigation up to the Supreme Court, where the issue is still pending. AGC opposes the method, not the objective. AGC is sincerely interested in bringing a maximum number of minority business enterprises into the construction industry. Consistent with this goal, we would highly recommend that the economic reality test or "investment management" test be recognized as one of the best ways we know for accomplishing the objective in a proper and effective manner.

In addition, Mr. Chairman, we suggest a third "safe harbor" for those workers who hold themselves out as independent contractors and who either worked for five or more payors during the previous year, or who anticipate working for five or more payors during the current year. This, of course, is based on Sec'y. Lubick's proposal that "no withholding would be required on payments to an individual who provides similar services to five or more payors during each calendar year."

This makes sense and is incorporated into subsection (d) of the Crane bill. This subsection also makes sense to the argument for no withholding. If a very large group of the self employed are to be exempt from withholding on recommendation of the IRS, why should

the Congress strive to discriminate against all other independent contractors?

Mr. Chairman, if the individual is not qualified under the five points of Dole and Gephardt; or, the Crane "safe harbors," the statute should still give him the opportunity to qualify as an independent contractor under the current IRS common law definition of an independent contractor. AGC recommends therefore that the committee include in the Dole bill a no-inference section; Sec. 3142-03(5-71)[5] of the IRS Training Manual. In other words, the current IRS definition should be codified into the statute to preclude later attrition by IRS expansion of the present common law test to enlarge the employee definition and narrow the independent contractor definition.

The IRS, a governmental agency which does not normally embrace the common law, has at least issued regulations and revenue rulings which provide common law guidelines. In the general rules for execution of the complicated form SS-8, it is stated, "The determination of whether a worker is an employee, for purposes of the federal insurance contributions act, the federal unemployment tax act, and the income tax withholding provisions of the internal revenue code, is based on the usual common law rules applicable in determining the employer-employee relationship." However, to preclude arbitrary changes in the criteria, the above regulations should be codified.

Mr. Chairman, the Gephardt and Crane bills have no-inference sections. That is, the provisions state there is no inference that those independent contractors not in the "safe harbors" are to be considered employees. This is especially important when we note that the first sentence of section 3142-03 of the IRS Training Manual states:

"One of the most common mistakes made in making employer-employee determinations is that agents do not fully develop their case."

Congressman Gephardt, in his House testimony, pointed out that IRS has made an apparent, abrupt about face in its public approach to common law as it relates to independent contractors. He emphasized Sec'y. Lubick was saying that the IRS was now ready to accept the common law if Congress would accept withholding for independent contractors. Although Congressman Gephardt did not say it, some might charge that this so-called "offer too good to refuse" is beneath the dignity of the Congress.

The Gephardt bill, H.R. 3245, and the Crane bill, H.R. 5266 do not include the twenty criteria that the courts evaluate during litigation. Codifying these criteria, of course, would not preclude the courts from adding new factors.

It would, however, as mentioned, preclude IRS from changing its mind at some time in the future and arbitrarily reducing the scope of the independent contractor definition. Also, in this way, Congress would maintain control, not only over the criteria of the "safe harbors," but also those to be considered in making decisions under the common law generally.

In fact, at some time in the future, the Congress may want to determine if and how the twenty factors can be weighed comparatively in order to put all independent contractors, in effect, in a "safe harbor." This would completely eliminate unnecessary harassment and litigation which, as we understand, is the specific goal of this committee and the Congress.

Therefore, we suggest the legislation to read under Sec. 3508(f)(2): "any determination of such an issue shall be made after consideration of

no less than the following," and then list the 20 common law factors we have included in footnote 5. If this can be accomplished by report language, that would be fine.

In conclusion, Mr. Chairman, AGC does support another amendment to S. 736 requiring that all workers who are reclassified as independent contractors after date of enactment must come in under the economic reality test or the twenty common law criteria. This provision has been included in Section 3508(e)(2) of the Crane bill. This would eliminate the criticism of S. 736 that employers could automatically switch their employees to independent contractor status.

We feel this is a valid concern since the person's status would be changed from an employee to independent contractor and the element of coercion could become a factor. The Crane provision would eliminate the so called "switching," but would not affect newly-established independent contractors after the date of enactment.

The committee, however, might want to exclude, in report language, those "switches" who were previously independent contractors and were subsequently forced and/or harassed into employee status by IRS. I am sure the committee has been made aware of a number of "horror stories" in this regard.

We feel the Dole legislation is a good bill and can be strengthened by the Crane provisions. We have, Mr. Chairman, based our testimony on what we believe to be the common law and common sense.

Thank you for this opportunity to share this vital information with you. We hope it will be useful and we will be happy to attempt to answer any questions.

FOOTNOTE 1

UNITED STATES v. MUTUAL TRUCKING CO.

No. 9701.

Circuit Court of Appeals, Sixth Circuit.

April 7, 1944.

1. Internal revenue ⟹1129

The Social Security Act recognizes the common-law definition of independent contract and excludes such relationship from the burden of the tax. Social Security Act §§ 801 et seq., 901 et seq., 42 U.S.C.A. §§ 1001 et seq., 1101 et seq.

2. Internal revenue ⟹1129

In determining whether "owner-operators" of tractors and trailers were employees of trucking company so as to render company liable for social security or federal insurance contributions, the circumstance that to secure license plates, trucking company's president was compelled to apply to Interstate Commerce Commission and state that plates were to be displayed on vehicles operated by and under control of company was not conclusive, in view of Commission's recognition of operation of trucking companies through independent contract. Social Security Act, §§ 801 et seq., 901 et seq., 42 U.S.C.A. §§ 1001 et seq., 1101 et seq.; Federal Insurance Contribu-

tions Act, § 601 et seq., 26 U.S.C.A. Int. Rev.Code, § 1400 et seq.; Federal Employment Tax Act, § 608 et seq., 26 U.S.C.A.Int. Rev.Code, § 1600 et seq.; Interstate Commerce Act § 203(19), 49 U.S.C.A. § 303(19).

3. Internal revenue ⟹1129

In determining whether "owner-operators" of tractors and trailers were employees of trucking company so as to render company liable for social security or federal insurance contributions, that company usually did not know in advance what particular driver was to take the freight was cogent evidence that while company instructed owner-operators when and where to transport the freight it did not instruct them as to how to transport it. Social Security Act, §§ 801 et seq., 901 et seq., 42 U.S.C.A. §§ 1001 et seq., 1101 et seq.; Federal Insurance Contributions Act, § 601 et seq., 26 U.S.C.A. Int.Rev.Code § 1400 et seq.; Federal Employment Tax Act, § 608 et seq., 26 U.S.C.A.Int.Rev.Code, § 1600 et seq.

4. Internal revenue ⟹1129

Where a trucking company undertook to move loaded trailers from terminal to terminal of car loading company and contracted to have work done by owners of tractors and trailers, some of whom operated through employees, such owners, under evidence, were "independent contractors," and neither they nor their employees were "employees" of trucking company so as to render such company liable for social security or federal insurance contributions. Social Security Act, §§ 801 et seq., 901 et seq., 42 U.S.C.A. §§ 1001 et seq., 1101 et seq.; Federal Insurance Contributions Act, § 601 et seq., 26 U.S.C.A.Int.Rev.Code, § 1400 et seq.; Federal Employment Tax Act, § 608 et seq., 26 U.S.C.A.Int.Rev.Code, § 1600 et seq.

See Words and Phrases, Permanent Edition, for all other definitions of "Employee" and "Independent Contractor".

Appeal from the United States District Court for the Northern District of Ohio, Western Division; Frank LeBlond Kloeb, Judge.

Action by Mutual Trucking Company against the United States of America to recover taxes alleged to have been erroneously and illegally collected from plaintiff under the Social Security Act, the Federal Unemployment Tax Act, and the Federal Insurance Contributions Act. From a judgment for plaintiff, 51 F.Supp. 114, the defendant appeals.

Affirmed.

Frederic G. Rita, of Washington, D. C. (Samuel O. Clark, Jr., Sewall Key, A. F. Prescott, and Frederic G. Rita, all of Washington, D. C., Don C. Miller, of Cleveland, Ohio, and Gerald P. Openlander, of Toledo, Ohio, on the brief), for appellant.

Wilbur E. Benoy, of Columbus, Ohio (Wilbur E. Benoy and Arthur M. Sebastian, both of Columbus, Ohio, on the brief), for appellee.

Before ALLEN, HAMILTON, and McALLISTER, Circuit Judges.

ALLEN, Circuit Judge.

In an action for refund of taxes, from which the present appeal is prosecuted, the District Court entered a judgment for $7,504.54 with interest.

In 1941 the Collector of Internal Revenue amended and supplemented the appellee's returns for taxation under Titles VIII and IX of the Social Security Act, Title 42, U.S.C., § 1001 et seq. and § 1101 et seq., 42 U.S.C.A. §§ 1001 et seq. and 1101 et seq.; the Federal Unemployment Tax Act, Title 26, U.S.C., § 1600 et seq., 26 U.S.C.A.Int. Rev. Code, § 1600 et seq. and the Federal Insurance Contributions Act Title 26, U.S.C., § 1400 et seq., 26 U.S.C.A. Int.Rev.Code. § 1400 et seq., and assessed additional taxes aggregating the amount of the judgment. The additional taxes were based upon a determination that the appellee during the year 1939, in addition to amounts previously reported, had paid taxable wages amounting to $204,090.30. This amount was one-third of the total paid by appellee during the period in question to certain so-called "owner-operators" who performed trucking transportation for it under contracts hereinafter described. Each of the statutes involved imposes a liability for taxes upon "every employer * * * with respect to having individuals in his employ." The District Court held that the appellee was not the employer of the owner-operators nor of various persons working under them, but that the owner-operators were independent contractors, and that the taxes, penalty and interest charged against appellee had been erroneously and illegally assessed.

The facts are undisputed. The appellee is a corporation organized under the laws

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of the State of Illinois, having its principal place of business in Toledo, Ohio. During the entire period in question it contracted with certain owner-operators to do hauling for it in interstate commerce, under identical written contracts. which contained the following clause: "It is to be clearly understood and agreed, and it is the intention of the parties hereto, that Second Party [owner-operator] is a contractor only and is not the agent, employee or representative of First Party [appellee] for any purpose whatever." The contract also provided that the owner-operator should assume full responsibility for the payment of all state and federal taxes for unemployment insurance, old age pensions, or other social security laws as to all persons engaged in the performance of the contract.[1] This provision has been rigidly adhered to by both parties.

Since appellee and its corporate predecessors have been operating under similar contracts since prior to 1932, no question of tax evasion is involved. The owner-operators haul exclusively for the appellee, ordinarily using their own equipment which consists of a tractor and trailer, and being paid a flat rate for each trip, according to a printed schedule of which all owner-operators have notice in advance of the trip. The operation consists of the transfer of sealed and loaded trailers between the terminals of the Universal Car Loading and Distributing Company in Chicago, Milwaukee, Toledo and other important cities. Each owner-operator hires and discharges his drivers. The payment of the drivers, the cost of maintenance and repairs and the cost of operation are borne exclusively by the owner-operators. In compliance with the contract, individual insurance covering both property and tort liability is carried by the owner-operator. The equipment is marked usually "Operated for Mutual Trucking Company," but a number of trailers are marked only with the name of the owner-operator. The trucks carry plates secured from the Interstate Commerce Commission which are required by the rules of the Commission, and are applied for by the appellee, but each owner-operator secures his own state license plates and drivers' licenses. Each driver is compelled to carry an identification card which bears a statement that it must be returned when the bearer leaves "the Employ of the Company." The identification card was prepared and supplied not by the appellee, but by the insurance company interested in the operation. All drivers of trucks are required to register at stations maintained by appellee on the principal routes for the purpose of checking the time of the trip. No penalty is exacted by appellee if the shipment is delayed, but the appellee, in order to assist in prompt disposition of freight, requires that the drivers file a so-called "daily log" which indicates the number of driving hours and helps the appellee to know how far at a given time the load has progressed. The appellee has established a road patrol consisting of certain inspectors who drive on the routes in order

[1] "First Party hereby grants permission to Second Party, without charge or costs, as and when necessary and required, to use its certificates or permits for such hauling of freight as he may do for First Party, but for no other purpose whatever. All license tags, drivers' licenses, union fees or dues, fees assessed by municipal corporations, or other fees of any kind or character other than as herein provided, shall be paid and borne by said Second Party, and First Party shall have no responsibility whatever to Second Party, his drivers, helpers or employees for any fines, costs or expenses incurred by Second Party or any of his employees by reason of his or their failure to have proper markings on equipment, or by reason of any violation by second party or any of his employees, of any rule or order of the Bureau of Motor Carriers of the Interstate Commerce Commission, or any Public Utility Commission, or other authority of any state; and nothing in this contract shall be in any way construed to constitute Second Party or any of his agents or employees as the agent, employee or representative of First Party. Second Party also agrees that he will, at all times, comply with all laws, rules and/or regulations of the Bureau of Motor Carriers of the Interstate Commerce Commission, or any Public Utility Commission, or other authority of any state in and through which he may be operating under this contract with respect to workmen's compensation or other insurance for the benefit or protection of his employees, and that he will assume full responsibility for the payments of all State and Federal taxes for unemployment insurance, old age pensions, or other Social Security laws, as to all persons engaged in the performance of this contract, and further agrees to meet all requirements of regulations now or hereafter adopted or promulgated by legally constituted authority in respect thereto."

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to check on the observance by the truck drivers of statutes and regulations of the various commissions. In case any violation of law or the regulations is observed, the patrol, instead of reporting the matter to the appellee, reports to the police or to the Operators' Safety Council, a voluntary committee of the owner-operators which meets regularly to consider and to deal with such violations. One of appellant's witnesses testified that this committee penalized one of his men for driving recklessly and in effect forced him to dicharge the driver.

[1] In promulgating the regulations to implement Title VIII of the Social Security Act, the Commissioner of Internal Revenue stated that the employer-employee relationship generally exists "when the person for whom services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished. * * * In general. if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor. An individual performing services as an independent contractor is not as to such services an employee." The statute thus recognizes the common law definition of independent contract and excludes such relationship from the burden of the tax. American Oil Co. v. Fly, Collector, 5 Cir., 135 F.2d 491, 147 A. L.R. 824; Radio City Music Hall Corp. v. United States, 2 Cir., 135 F.2d 715; Texas Co. v. Higgins, 2 Cir., 118 F.2d 636; Indian Refining Co. v. Dallman, 7 Cir., 119 F. 2d 417, affirming D.C., 31 F.Supp. 455.

The District Court found that the appellee had no control over the drivers in any way inconsistent with the contract provisions. The Government maintains, however, that under the control exercised over the operation by appellee, the statutory relationship of employment exists. That this is not the universal construction by the tax authorities is shown by the fact that some ten owner-operators in the Chicago area and one owner-operator in Minnesota have paid the taxes covering their own driver employees, together with penalties, under the same statutes.

The contract clearly seeks to establish a relationship of independent contract. It specifically provides that it shall be governed by Ohio law. The Ohio decisions hold this relationship to be that of independent contract. Coviello v. Industrial Commission, 129 Ohio St. 589, 196 N.E. 661; Industrial Commission v. McAdow, 126 Ohio St. 198, 184 N.E. 759.

[2] The Government contends that the findings of the District Court are supported by no evidence, claiming that the operation through dispatchers and highway inspectors employed by appellee and the requirement of drivers' reports, all are evidence of such control as to necessitate a finding that the employer-employee relationship exists. It stresses the circumstance that in order to secure the license plates which, under the rules of the Interstate Commerce Commission, were required to be attached to trucks in operation, the president of the appellee company was compelled to make application to the Interstate Commerce Commission and expressly to state that such plates were to be displayed on motor vehicles operated by and under the control, supervision and responsibility of the appellee. We do not consider this fact conclusive. The Interstate Commerce Commission recognizes operation of trucking companies through independent contract, and in its auditing department reports this class of business under the heading "Purchased Transportation." Since the Motor Carrier Act, now part II of the Interstate Commerce Act, Title 49, U.S.C., § 301 et seq., 49 U.S.C.A. § 301 et seq., covers "all vehicles operated by, for, or in the interest of any motor carrier irrespective of ownership or of contract, express or implied" Title 49, U.S.C., § 303(19), 49 U.S. C.A. § 303(19), the present operation, so far from being condemned, is valid under federal law. The use of the plates and the form of the application therefor is clearly explained by the necessity for complying with the regulations of the Interstate Commerce Commission.

[3, 4] As opposed to this circumstance. the owner-operators select, discharge and pay their drivers. In the only case of penalization shown in the record, the penalty was suggested by the Operators' Safety Council and was enforced, not by the appellee. but by the owner-operator. Neither the drivers nor the owner-operators are under appellee's control with reference to the manner of their work. The important regulations which they observe grow out of and are imposed by the contract and the applic-

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able statutes and regulations. The drivers follow the routes required by the commissions of the various states, but with some deviation, and in such case, "upon their own responsibility." It is significant that the appellee in these transactions usually does not know in advance what particular driver is to take the freight. This is cogent evidence upon the proposition that while the appellee instructs the owner-operators when and where to transport the freight carried, it does not instruct them how to transport it. While both the appellee and the owner-operators have an interest in the transportation, and the responsibility is divided between them, clearly there is not such control as to create the relationship of employment between the appellee and owner-operators or the drivers.

Congress might have provided that such a relationship should be considered an employment, but it has not done so. In fact the Senate rejected a House amendment which would have extended the coverage in the statute beyond the employment relationship. The House receded (Conference Report, August 4, 1939, to accompany House Resolution 6635, page 14), and the Act was passed with coverage limited to employees. Moreover, the recent definition in the Current Tax Payment Act of 1943 defines employer as follows:

"(d) Employer. The term 'employer' means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

"(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' * * * means the person having control of the payment of such wages * * *." 26 U.S.C. Int.Rev.Code, § 1621 (d), 26 U.S.C.A. Int.Rev.Code § 1621(d).

In this case concededly the owner-operators completely control payment of the wages.

These considerations require affirmance of the judgment. We have recently made a similar decision in Glenn, Collector, v. Beard, 6 Cir., 141 F.2d 376. Our conclusion is in accord with the great weight of authority both in federal and state decisions upon this question. Texas Co. v. Higgins, supra; Williams v. United States, 7 Cir., 126 F.2d 129; Robinson v. Baltimore & Ohio R. Co., 237 U.S. 84, 35 S.Ct. 491, 59 L.Ed. 849; Government Personnel Automobile Ass'n v. United States, 5 Cir., 124 F.2d 99. Cf. Midwest Haulers, Inc., v. Brady, 6 Cir., 128 F.2d 496, 499; Walling v. Sanders, 6 Cir., 136 F.2d 78, which construed a similar provision of the Fair Labor Standards Act, 29 U.S.C., § 201 et seq., 29 U.S.C.A. § 201 et seq.; State ex rel. Zone Cab Corp. v. Industrial Commission, 132 Ohio St. 156, 5 N.E.2d 477; Coviello v. Industrial Commission, supra; Gillum v. Industrial Commission, 141 Ohio St. 373, 48 N.E.2d 234.

Our decision in Western Express Co. v. Smeltzer, 88 F.2d 94, 112 A.L.R. 74, is not in conflict. While the operation there presented certain features similar to those presented here, the question was one of tort liability and not of contract relationship. No written agreement existed between the Western Express Company and the operator of the truck in the Smeltzer case. Here a contract, which is specific in every detail, has been meticulously followed by the parties, and expressly provides that the relationship is one of independent contract. Moreover, the control exercised by the carrier over the details of the operation in the Smeltzer case was more definite than in the instant case. There the drivers were subject to the call of the carrier while in Chicago, and the reports filed evidence a greater degree of control than the drivers' log used here. Explanation of delay was required to be given, and details of expense to be reported. No construction of a statute was involved, and the sole question was whether there was sufficient evidence of control to sustain a jury verdict in a court action. Obviously this is a question to be determined by canons of construction different from those used to determine the question of liability for tax under specific statutes.

We are confirmed in our conclusion by the fact that the tax is expressly required to be computed upon the total wages paid or payable by the employer. Title 42, U.S.C., §§ 1001, 1101, 42 U.S.C.A. §§ 1001, 1101; Title 26, U.S.C., §§ 1400, 1600, 26 U.S.C.A. Int.Rev.Code, §§ 1400, 1600. In this case the appellee paid no wages. The record shows in two instances what wages were paid by the owner-operator. It was testified that the driver received the union scale of two cents a mile. If all wages were paid by this scale they would not exceed twenty-one per cent of the full amount paid to the owner-operators by the appellee. However, the Collector, without any evi-

dence upon this question, determined that a third of the sum paid to the owner-operators constituted wages. This was an arbitrary and illegal determination. Presumably the wages may have varied as between the different owner-operators. As was persuasively said in an analogous decision of the Supreme Court of Ohio, "The undisputed facts in this case show the impossibility of determining premiums based upon a payroll when there is none, and there can be none in such a situation." Coviello v. Industrial Commission, supra [129 Ohio St. 589, 196 N.E. 663].

The judgment is affirmed.

FOOTNOTE 2

UNITED STATES *v.* SILK, DOING BUSINESS AS ALBERT SILK COAL CO.

NO. 312. CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.*

Argued March 10, 1947.—Decided June 16, 1947.

1. In determining whether particular workers are independent contractors or "employees" within the meaning of the Social Security Act, the same rules are applicable as were applied by this Court to the National Labor Relations Act in *Labor Board* v. *Hearst Publications*, 322 U. S. 111. Pp. 713-714.
2. Unloaders of coal who provide their own tools, work only when they wish to work and are paid an agreed price per ton to unload coal from railroad cars, *held*, in the circumstances of this case, to be "employees" within the meaning of the Social Security Act. Pp. 706, 716-718.
3. Truck drivers who own their own trucks, pay the expenses of their operation, employ and pay their own helpers and receive compensation on a piece-work or percentage basis, *held*, in the circumstances of these cases, to be independent contractors and not "employees" within the meaning of the Social Security Act. Pp. 706-710, 718-719.

155 F. 2d 356, affirmed in part and reversed in part.
156 F. 2d 412, affirmed.

No. 312. The District Court granted respondents a judgment for a refund of social security taxes. The Circuit Court of Appeals affirmed. 155 F. 2d 356. This Court granted certiorari. 329 U. S. 702. *Affirmed in part and reversed in part*, p. 719.

No. 673. The District Court granted respondent a judgment for a refund of social security taxes. The Circuit Court of Appeals affirmed. 156 F. 2d 412. This Court granted certiorari. 329 U. S. 709. *Affirmed*, p. 719.

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*Together with No. 673, *Harrison, Collector of Internal Revenue*, v. *Greyvan Lines, Inc.*, on certiorari to the Circuit Court of Appeals for the Seventh Circuit, argued March 10, 11, 1947.

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Robert L. Stern argued the cause for petitioners. With him on the briefs were *Acting Solicitor General Washington, Sewall Key* and *Lyle M. Turner*. *Jack B. Tate* was also with them on the brief in No. 312.

Ralph F. Glenn argued the cause for respondent in No. 312. With him on the brief were *Robert Stone* and *Warren W. Shaw*.

Wilbur E. Benoy argued the cause for respondent in No. 673. With him on the brief were *Arthur M. Sebastian* and *Robert Driscoll*.

MR. JUSTICE REED delivered the opinion of the Court.

We consider together the above two cases. Both involve suits to recover sums exacted from businesses by the Commissioner of Internal Revenue as employment taxes on employers under the Social Security Act.[1] In both instances the taxes were collected on assessments made administratively by the Commissioner because he concluded the persons here involved were employees of the taxpayers. Both cases turn on a determination as to whether the workers involved were employees under that Act or whether they were independent contractors. Writs of certiorari were granted, 329 U. S. 702 and 329 U. S. 709, because of the general importance in the collection of social security taxes of deciding what are the applicable standards for the determination of employees under the Act. Varying standards have been applied in the federal courts.[2]

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[1] Titles VIII and IX, Social Security Act, 49 Stat. 636 and 639, as repealed in part 53 Stat. 1.

See Internal Revenue Code, chap. 9, subchap. A and C.

[2] *Texas Co.* v. *Higgins*, 118 F. 2d 636; *Jones* v. *Goodson*, 121 F. 2d 176; *Deecy Products Co.* v. *Welch*, 124 F. 2d 592; *American Oil Co.* v. *Fly*, 135 F. 2d 491; *Glenn* v. *Beard*, 141 F. 2d 376; *Magruder* v. *Yellow*

Respondent in No. 312, Albert Silk, doing business as the Albert Silk Coal Co., sued the United States, petitioner, to recover taxes alleged to have been illegally assessed and collected from respondent for the years 1936 through 1939 under the Social Security Act. The taxes were levied on respondent as an employer of certain workmen some of whom were engaged in unloading railway coal cars and the others in making retail deliveries of coal by truck.

Respondent sells coal at retail in the city of Topeka, Kansas. His coalyard consists of two buildings, one for an office and the other a gathering place for workers, railroad tracks upon which carloads of coal are delivered by the railroad, and bins for the different types of coal. Respondent pays those who work as unloaders an agreed price per ton to unload coal from the railroad cars. These men come to the yard when and as they please and are assigned a car to unload and a place to put the coal. They furnish their own tools, work when they wish and work for others at will. One of these unloaders testified that he worked as regularly "as a man has to when he has to eat" but there was also testimony that some of the unloaders were floaters who came to the yard only intermittently.

Respondent owns no trucks himself but contracts with workers who own their own trucks to deliver coal at a uniform price per ton. This is paid to the trucker by the respondent out of the price he receives for the coal from the customer. When an order for coal is taken in the company office, a bell is rung which rings in the building used by the truckers. The truckers have voluntarily

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Cab Co., 141 F. 2d 324; *United States* v. *Mutual Trucking Co.*, 141 F. 2d 655; *Glenn* v. *Standard Oil Co.*, 148 F. 2d 51, 53; *McGowan* v. *Lazeroff*, 148 F. 2d 512; *United States* v. *Wholesale Oil Co.*, 154 F. 2d 745; *United States* v. *Vogue, Inc.*, 145 F. 2d 609, 612; *United States* v. *Aberdeen Aerie No. 24*, 148 F. 2d 655, 658; *Grace* v. *Magruder*, 148 F. 2d 679, 680–81; *Nevins, Inc.* v. *Rothensies*, 151 F. 2d 189.

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adopted a call list upon which their names come up in turn, and the top man on the list has an opportunity to deliver the coal ordered. The truckers are not instructed how to do their jobs, but are merely given a ticket telling them where the coal is to be delivered and whether the charge is to be collected or not. Any damage caused by them is paid for by the company. The District Court found that the truckers could and often did refuse to make a delivery without penalty. Further, the court found that the truckers may come and go as they please and frequently did leave the premises without permission. They may and did haul for others when they pleased. They pay all the expenses of operating their trucks, and furnish extra help necessary to the delivery of the coal and all equipment except the yard storage bins. No record is kept of their time. They are paid after each trip, at the end of the day or at the end of the week, as they request.

The Collector ruled that the unloaders and truckers were employees of the respondent during the years 1936 through 1939 within the meaning of the Social Security Act and he accordingly assessed additional taxes under Titles VIII and IX of the Social Security Act and Subchapters A and C of Chapter 9 of the Internal Revenue Code. Respondent filed a claim for a refund which was denied. He then brought this action. Both the District Court and the Circuit Court of Appeals[3] thought that the truckers and unloaders were independent contractors and allowed the recovery.

Respondent in No. 673, Greyvan Lines, Inc., a common carrier by motor truck, sued the petitioner, a Collector of Internal Revenue, to recover employment taxes alleged to have been illegally assessed and collected from it under similar provisions of the Social Security Act involved in

[3] 155 F. 2d 356.

Silk's case for the years or parts of years 1937 through the first quarter of 1942. From a holding for the respondent in the District Court petitioner appealed. The Circuit Court of Appeals affirmed. The chief question in this case is whether truckmen who perform the actual service of carrying the goods shipped by the public are employees of the respondent. Both the District Court and the Circuit Court of Appeals[4] thought that the truckmen were independent contractors.

The respondent operates its trucking business under a permit issued by the Interstate Commerce Commission under the "grandfather clause" of the Motor Carrier Act. 32 M. C. C. 719, 723. It operates throughout thirty-eight states and parts of Canada, carrying largely household furniture. While its principal office is in Chicago, it maintains agencies to solicit business in many of the larger cities of the areas it serves, from which it contracts to move goods. As early as 1930, before the passage of the Social Security Act, the respondent adopted the system of relations with the truckmen here concerned, which gives rise to the present issue. The system was based on contracts with the truckmen under which the truckmen were required to haul exclusively for the respondent and to furnish their own trucks and all equipment and labor necessary to pick up, handle and deliver shipments, to pay all expenses of operation, to furnish all fire, theft, and collision insurance which the respondent might specify, to pay for all loss or damage to shipments and to indemnify the company for any loss caused it by the acts of the truckmen, their servants and employees, to paint the designation "Greyvan Lines" on their trucks, to collect all money due the company from shippers or consignees, and to turn in such moneys at the office to which they report after delivering a shipment, to post bonds with the

[4] 156 F. 2d 412.

company in the amount of $1,000 and cash deposits of $250 pending final settlement of accounts, to personally drive their trucks at all times or be present on the truck when a competent relief driver was driving (except in emergencies, when a substitute might be employed with the approval of the company), and to follow all rules, regulations, and instructions of the company. All contracts or bills of lading for the shipment of goods were to be between the respondent and the shipper. The company's instructions covered directions to the truckmen as to where and when to load freight. If freight was tendered the truckmen, they were under obligation to notify the company so that it could complete the contract for shipment in its own name. As remuneration, the truckmen were to receive from the company a percentage of the tariff charged by the company varying between 50 and 52% and a bonus up to 3% for satisfactory performance of the service. The contract was terminable at any time by either party. These truckmen were required to take a short course of instruction in the company's methods of doing business before carrying out their contractual obligations to haul. The company maintained a staff of dispatchers who issued orders for the truckmen's movements, although not the routes to be used, and to which the truckmen, at intervals, reported their positions. Cargo insurance was carried by the company. All permits, certificates and franchises "necessary to the operation of the vehicle in the service of the Company as a motor carrier under any Federal or State Law" were to be obtained at the company's expense.

The record shows the following additional undisputed facts, not contained in the findings. A manual of instructions, given by the respondent to the truckmen, and a contract between the company and Local No. 711 of the International Brotherhood of Teamsters, Chauffeurs, Stablemen and Helpers of America were introduced in evi-

dence. It suffices to say that the manual purported to regulate in detail the conduct of the truckmen in the performance of their duties, and that the agreement with the Union provided that any truckman must first be a member of the union, and that grievances would be referred to representatives of the company and the union. A company official testified that the manual was impractical and that no attempt was made to enforce it. We understand the union contract was in effect. The company had some trucks driven by truckmen who were admittedly company employees. Operations by the company under the two systems were carried out in the same manner. The insurance required by the company was carried under a blanket company policy for which the truckmen were charged proportionately.

The Social Security Act of 1935 was the result of long consideration by the President and Congress of the evil of the burdens that rest upon large numbers of our people because of the insecurities of modern life, particularly old age and unemployment. It was enacted in an effort to coordinate the forces of government and industry for solving the problems.[5] The principal method adopted by Congress to advance its purposes was to provide for periodic payments in the nature of annuities to the elderly and compensation to workers during periods of unemployment. Employment taxes, such as we are here considering, are necessary to produce the revenue for federal participation in the program of alleviation. Employers do not pay taxes on certain groups of employees, such as agricultural or domestic workers

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[5] Message of the President, January 17, 1935, and Report of the Committee on Economic Security, H. Doc. No. 81, 74th Cong., 1st Sess.; S. Rep. No. 628, 74th Cong., 1st Sess.; S. Rep. No. 734, 76th Cong., 1st Sess.; H. Rep. No. 615, 74th Cong., 1st Sess.; H. Rep. No. 728, 76th Cong., 1st Sess. *Steward Machine Co.* v. *Davis*, 301 U. S. 548; *Helvering* v. *Davis*, 301 U. S. 619.

but none of these exceptions are applicable to these cases. §§ 811 and 907. Taxes are laid as excises on a percentage of wages paid the nonexempt employees. §§ 804 and 901; I. R. C. §§ 1410, 1600. "Wages" means all remuneration for the employment that is covered by the Act, cash or otherwise. §§ 811, 907; I. R. C. §§ 1426, 1607 (b). "Employment" means "any service, of whatever nature, performed . . . by an employee for his employer, except . . . Agricultural labor" *et cetera.* §§ 811 (b), 907 (c); I. R. C. §§ 1426 (b), 1607 (c). As a corollary to the coverage of employees whose wages are the basis for the employment taxes under the tax sections of the social security legislation, rights to benefit payments under federal old age insurance depend upon the receipt of wages as employees under the same sections. 53 Stat. 1360, §§ 202, 209 (a), (b), (g), 205 (c) (1). See *Social Security Board* v. *Nierotko,* 327 U. S. 358. This relationship between the tax sections and the benefit sections emphasizes the underlying purpose of the legislation—the protection of its beneficiaries from some of the hardships of existence. *Helvering* v. *Davis, supra,* 640. No definition of employer or employee applicable to these cases occurs in the Act. See § 907 (a) and I. R. C. § 1607 (a). Compare, as to carrier employment, I. R. C. § 1532 (d), as amended by 60 Stat. 722, § 1. Nothing that is helpful in determining the scope of the coverage of the tax sections of the Social Security Act has come to our attention in the legislative history of the passage of the Act or amendments thereto.

Since Congress has made clear by its many exemptions, such as, for example, the broad categories of agricultural labor and domestic service, 53 Stat. 1384, 1393, that it was not its purpose to make the Act cover the whole field of service to every business enterprise, the sections in question are to be read with the exemptions in mind. The very specificity of the exemptions, however, and the gen-

erality of the employment definitions[6] indicates that the terms "employment" and "employee," are to be construed to accomplish the purposes of the legislation. As the federal social security legislation is an attack on recognized evils in our national economy, a constricted interpretation of the phrasing by the courts would not comport with its purpose. Such an interpretation would only make for a continuance, to a considerable degree, of the difficulties for which the remedy was devised and would invite adroit schemes by some employers and employees to avoid the immediate burdens at the expense of the benefits sought by the legislation.[7] These considerations have heretofore guided our construction of the Act. *Buckstaff Bath House Co.* v. *McKinley*, 308 U. S. 358; *Social Security Board* v. *Nierotko*, 327 U. S. 358.

Of course, this does not mean that all who render service to an industry are employees. Compare *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 520. Obviously the private contractor who undertakes to build at a fixed price or on cost-plus a new plant on specifications is not an employee of the industry thus served nor are his employees. The distributor who undertakes to market at his own risk the product of another, or the producer who agrees so to manufacture for another, ordinarily cannot be said to have the employer-employee relationship. Production and distribution are different segments of business. The purposes of the legislation are not frustrated because the Govern-

[6] See 53 Stat. 1384, 1393, "The term 'employment' means any service performed prior to January 1, 1940, which was employment as defined in this section prior to such date, and any service, of whatever nature, performed after December 31, 1939, within the United States by an employee for the person employing him, irrespective of the citizenship or residence of either, except— . . . ." Compare 49 Stat. 639 and 643.

[7] Nothing to suggest tax avoidance appears in these records.

ment collects employment taxes from the distributor instead of the producer or the other way around.

The problem of differentiating between employee and an independent contractor, or between an agent and an independent contractor, has given difficulty through the years before social legislation multiplied its importance. When the matter arose in the administration of the National Labor Relations Act, we pointed out that the legal standards to fix responsibility for acts of servants, employees or agents had not been reduced to such certainty that it could be said there was "some simple, uniform and easily applicable test." The word "employee," we said, was not there used as a word of art, and its content in its context was a federal problem to be construed "in the light of the mischief to be corrected and the end to be attained." We concluded that, since that end was the elimination of labor disputes and industrial strife, "employees" included workers who were such as a matter of economic reality. The aim of the Act was to remedy the inequality of bargaining power in controversies over wages, hours and working conditions. We rejected the test of the "technical concepts pertinent to an employer's legal responsibility to third persons for acts of his servants." This is often referred to as power of control, whether exercised or not, over the manner of performing service to the industry. Restatement of the Law, Agency, § 220. We approved the statement of the National Labor Relations Board that "the primary consideration in the determination of the applicability of the statutory definition is whether effectuation of the declared policy and purposes of the Act comprehend securing to the individual the rights guaranteed and protection afforded by the Act." *Labor Board* v. *Hearst Publications*, 322 U. S. 111, 120, 123, 124, 128, 129, 131.

Application of the social security legislation should follow the same rule that we applied to the National Labor

Relations Act in the *Hearst* case. This, of course, does not leave courts free to determine the employer-employee relationship without regard to the provisions of the Act. The taxpayer must be an "employer" and the man who receives wages an "employee." There is no indication that Congress intended to change normal business relationships through which one business organization obtained the services of another to perform a portion of production or distribution. Few businesses are so completely integrated that they can themselves produce the raw material, manufacture and distribute the finished product to the ultimate consumer without assistance from independent contractors. The Social Security Act was drawn with this industrial situation as a part of the surroundings in which it was to be enforced. Where a part of an industrial process is in the hands of independent contractors, they are the ones who should pay the social security taxes.

The long-standing regulations of the Treasury and the Federal Security Agency (H. Doc. 595, 79th Cong., 2d Sess.) recognize that independent contractors exist under the Act. The pertinent portions are set out in the margin.[8] Certainly the industry's right to control how "work shall be done" is a factor in the determination of whether the worker is an employee or independent contractor.

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[8] Treasury Regulations 90, promulgated under Title IX of the Social Security Act, Art. 205:

"Generally the relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to *what* shall be done but *how* it shall be done. . . . The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direc-

The Government points out that the regulations were construed by the Commissioner of Internal Revenue to cover the circumstances here presented. This is shown by his additional tax assessments. Other instances of such administrative determinations are called to our attention.[9]

So far as the regulations refer to the effect of contracts, we think their statement of the law cannot be challenged successfully. Contracts, however "skilfully devised," *Lucas* v. *Earl*, 281 U. S. 111, 115, should not be permitted to shift tax liability as definitely fixed by the statutes.[10]

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tion of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor, not an employee.

"If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if two individuals in fact stand in the relation of employer and employee to each other, it is of no consequence that the employee is designated as a partner, coadventurer, agent, or independent contractor.

"The measurement, method, or designation of compensation is also immaterial, if the relationship of employer and employee in fact exists.

"Individuals performing services as independent contractors are not employees. Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are independent contractors and not employees." 26 C. F. R. § 400.205. See also Treasury Regulations 91, 26 C. F. R. § 401.3. (Emphasis added.)

[9] The citation of these cases does not imply approval or disapproval of the results. The cases do show the construction of the regulation by the agency. *United States* v. *Mutual Trucking Co.*, 141 F. 2d 655; *Jones* v. *Goodson*, 121 F. 2d 176; *Magruder* v. *Yellow Cab Co.*, 141 F. 2d 324; *Texas Co.* v. *Higgins*, 118 F. 2d 636; *American Oil Co.* v. *Fly*, 135 F. 2d 491; *Glenn* v. *Standard Oil Co.*, 148 F. 2d 51.

See also note 2.

[10] *Gregory* v. *Helvering*, 293 U. S. 465; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S. 473; *Helvering* v. *Clifford*, 309 U. S. 331.

Probably it is quite impossible to extract from the statute a rule of thumb to define the limits of the employer-employee relationship. The Social Security Agency and the courts will find that degrees of control, opportunities for profit or loss, investment in facilities, permanency of relation and skill required in the claimed independent operation are important for decision. No one is controlling nor is the list complete. These unloaders and truckers and their assistants are from one standpoint an integral part of the businesses of retailing coal or transporting freight. Their energy, care and judgment may conserve their equipment or increase their earnings but Greyvan and Silk are the directors of their businesses. On the other hand, the truckmen hire their own assistants, own their trucks, pay their own expenses, with minor exceptions, and depend upon their own initiative, judgment and energy for a large part of their success.

Both lower courts in both cases have determined that these workers are independent contractors. These inferences were drawn by the courts from facts concerning which there is no real dispute. The excerpts from the opinions below show the reasons for their conclusions.[11]

Giving full consideration to the concurrence of the two lower courts in a contrary result, we cannot agree that the

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[11] *United States* v. *Silk*, 155 F. 2d 356, 358-9: "But even while they work for appellee they are not subject to his control as to the method or manner in which they are to do their work. The undisputed evidence is that the only supervision or control ever exercised or that could be exercised over the haulers was to give them the sales ticket if they were willing to take it, and let them deliver the coal. They were free to choose any route in going to or returning. They were not required even to take the coal for delivery.

"We think that the relationship between appellee and the unloaders is not materially different from that between him and the haulers. In response to a question on cross examination, appellee did testify that the unloaders did what his superintendent at the coal yard told them to do, but when considered in the light of all his testimony, all that

unloaders in the *Silk* case were independent contractors.[12] They provided only picks and shovels. They had no opportunity to gain or lose except from the work of their

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this answer meant was that they unloaded the car assigned to them into the designated bin. . . .

"The undisputed facts fail to establish such reasonable measure of direction and control over the method and means of performing the services performed by these workers as is necessary to establish a legal relationship of employer and employee between appellee and the workers in question."

Greyvan Lines v. *Harrison*, 156 F. 2d 412, 414–16. After stating the trial court's finding that the truckmen were not employees, the appellate court noted:

"Appellant contends that in determining these facts the court failed to give effect to important provisions of the contracts which it asserts clearly show the reservation of the right of control over the truckmen and their helpers as to the methods and means of their operations which, it is agreed, furnish the test for determining the relationship here in question. . . ."

It then discussed the manual and concluded:

"While it is true that many provisions of the manual, if strictly enforced, would go far to establish an employer-employee relationship between the Company and its truckmen, we agree with appellee that there was evidence to justify the court's disregarding of it. It was not prepared until April, 1940, although the tax period involved was from November, 1937, through March, 1942, and there was no evidence to show any change or tightening of controls after its adoption and distribution; one driver testified that he was never instructed to follow the rules therein provided; an officer of the Company testified that it had been prepared by a group of three men no longer in their employ, and that it had been impractical and was not adhered to."

After a discussion of the helper problem, this statement appears: ". . . the Company cannot be held liable for employment taxes on the wages of persons over whom it exerts no control, and of whose employment it has no knowledge. And this element of control of the truckmen over their own helpers goes far to prevent the employer-employee relationship from arising between them and the Company. While many factors in this case indicate such control as to give rise to that relationship, we think the most vital one is missing because of the complete control of the truckmen as to how many, if any, and what helpers they make use of in their operations. . . ."

[12] Cf. *Grace* v. *Magruder*, 148 F. 2d 679.

hands and these simple tools. That the unloaders did not work regularly is not significant. They did work in the course of the employer's trade or business. This brings them under the coverage of the Act.[13] They are of the group that the Social Security Act was intended to aid. Silk was in a position to exercise all necessary supervision over their simple tasks. Unloaders have often been held to be employees in tort cases.[14]

There are cases, too, where driver-owners of trucks or wagons have been held employees [15] in accident suits at

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[13] I. R. C., chap. 9, subchap. A, § 1426 (b), as amended, 53 Stat. 1384:

"The term 'employment' means any service performed . . . by an employee for the person employing him . . . except—

* * * *

"(3) Casual labor not in the course of the employer's trade or business; . . ."

[14] *Swift & Co.* v. *Alston*, 48 Ga. App. 649, 173 S. E. 741; *Holmes* v. *Tennessee Coal, I. & R. Co.*, 49 La. Ann. 1465, 22 So. 403; *Muncie Foundry Co.* v. *Thompson*, 70 Ind. App. 157, 123 N. E. 196; *Chicago, R. I. & P. R. Co.* v. *Bennett*, 36 Okla. 358, 128 P. 705; *Murray's Case*, 130 Me. 181, 154 A. 352; *Decatur R. Co.* v. *Industrial Board*, 276 Ill. 472, 114 N. E. 915; *Benjamin* v. *Fertilizer Co.*, 169 Miss. 162, 152 So. 839.

[15] *Western Express Co.* v. *Smeltzer*, 88 F. 2d 94; *Industrial Commission* v. *Bonfils*, 78 Colo. 306, 241 P. 735; *Coppes Bros. & Zook* v. *Pontius*, 76 Ind. App. 298, 131 N. E. 845; *Burruss* v. *B. M. C. Logging Co.*, 38 N. M. 254, 31 P. 2d 263; *Bradley* v. *Republic Creosoting Co.*, 281 Mich. 177, 274 N. W. 754; *Rouse* v. *Town of Bird Island*, 169 Minn. 367, 211 N. W. 327; *Industrial Commission* v. *Hammond*, 77 Colo. 414, 236 P. 1006; *Kirk* v. *Lime Co. & Insurance Co.*, 137 Me. 73, 15 A. 2d 184; *Showers* v. *Lund*, 123 Neb. 56, 242 N. W. 258; *Burt* v. *Davis-Wood Lumber Co.*, 157 La. 111, 102 So. 87; *Dunn* v. *Reeves Coal Yards Co., Inc.*, 150 Minn. 282, 184 N. W. 1027; *Waters* v. *Pioneer Fuel Co.*, 52 Minn. 474, 55 N. W. 52; *Warner* v. *Hardwood Lumber Co.*, 231 Mich. 328, 204 N. W. 107; *Frost* v. *Blue Ridge Timber Corp.*, 158 Tenn. 18, 11 S. W. 2d 860; *Lee* v. *Mark H. Brown Lumber Co.*, 15 La. App. 294, 131 So. 697.

See particularly *Singer Manufacturing Co.* v. *Rahn*, 132 U. S. 518.

tort or under workmen's compensation laws. But we agree with the decisions below in *Silk* and *Greyvan* that where the arrangements leave the driver-owners so much responsibility for investment and management as here, they must be held to be independent contractors.[16] These driver-owners are small businessmen. They own their own trucks. They hire their own helpers. In one instance they haul for a single business, in the other for any customer. The distinction, though important, is not controlling. It is the total situation, including the risk undertaken, the control exercised, the opportunity for profit from sound management, that marks these driver-owners as independent contractors.

No. 312, *United States* v. *Silk*, is affirmed in part and reversed in part.

No. 673, *Harrison* v. *Greyvan Lines, Inc.*, is affirmed.

MR. JUSTICE BLACK, MR. JUSTICE DOUGLAS and MR. JUSTICE MURPHY are of the view that the applicable principles of law, stated by the Court and with which they agree, require reversal of both judgments in their entirety.

MR. JUSTICE RUTLEDGE.

I join in the Court's opinion and in the result insofar as the principles stated are applied to the unloaders in the *Silk* case. But I think a different disposition should be made in application of those principles to the truckers in that case and in the *Greyvan* case.

So far as the truckers are concerned, both are borderline cases.[1] That would be true, I think, even if the so-

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[16] Compare *United States* v. *Mutual Trucking Co.*, 141 F. 2d 655; *Glenn* v. *Standard Oil Co.*, 148 F. 2d 51.

[1] The opinion of the Circuit Court of Appeals in the *Greyvan* case stated, after referring to *United States* v. *Mutual Trucking Co.*, 141 F. 2d 655: "It is true that the facts there do not present as close a question as in the case at bar." And see note 3.

called "common law control" test were conclusive,[2] as the District Court and the Circuit Court of Appeals in each case seem to have regarded it.[3] It is even more true under

[2] It is not at all certain that either Silk or Greyvan Lines would not be held liable in tort, under application of the common law test, for injuries negligently inflicted upon persons or property of others by their truckers, respectively, in the course of operating the trucks in connection with their businesses. Indeed this result would seem to be clearly indicated, in the case of Greyvan particularly, in view of the fact that the trucks bore its name, in addition to other factors including a large degree of control exercised over the trucking operations. For federal cases in point see *Silent Automatic Sales Corp.* v. *Stayton*, 45 F. 2d 471 (applying Missouri law); *Falstaff Brewing Corp.* v. *Thompson*, 101 F. 2d 301 (applying Nebraska law); *Young* v. *Wilky Carrier Corp.*, 54 F. Supp. 912, aff'd, 150 F. 2d 764 (applying Pennsylvania law). And see for a general collection of state cases, 9 Blashfield, Cyclopedia of Automobile Law and Practice (1941) § 6056.

Certainly the question of coverage under the statute, as an employee, should not be determined more narrowly than that of employee status for purposes of imposing vicarious liability in tort upon an employer, whether by application of the control test exclusively or of the Court's broader ruling.

[3] In the *Silk* case formal findings of fact and conclusions of law by the District Court do not appear in the record. But a "Statement by the Court" recites details of the arrangements with the truckers and unloaders in the focus of whether Silk exercised control over them and concludes he did not; hence, there was no employer-employee relation. The opinion of the Circuit Court of Appeals, though recognizing the necessity for liberal construction of the Act, treats the facts found in the same focus of control. The court was influenced by the regulations promulgated under the Act (Reg. 90, Art. 205) and also by the Bureau of Internal Revenue (Reg. 91, Art. 3). The opinion concludes: "The undisputed facts fail to establish such reasonable measure of direction and control over the method and means of performing the services . . . as is necessary" to create the employer-employee relation. 155 F. 2d 356, 359.

In the *Greyvan* case formal findings and conclusions were filed. The Circuit Court of Appeals, accepting the findings, concluded they did not show "change or tightening of controls" after the company's adoption of a manual in 1940, although its provisions "if strictly en-

the broader and more factual approach the Court holds should be applied.

I agree with the Court's views in adopting this approach and that the balance in close cases should be cast in favor of rather than against coverage, in order to fulfill the statute's broad and beneficent objects. A narrow, constricted construction in doubtful cases only goes, as indeed the opinion recognizes, to defeat the Act's policy and purposes *pro tanto*.

But I do not think it necessary or perhaps in harmony with sound practice, considering the nature of this Court's functions and those of the district courts, for us to undertake drawing the final conclusion generally in these borderline cases. Having declared the applicable principles of law to be applied, our function is sufficiently discharged by seeing to it that they are observed. And when this has been done, drawing the final conclusion, in matters so largely factual as the end result must be in close cases, is more properly the business of the district courts than ours.

Here the District Courts and the Circuit Courts of Appeals determined the cases largely if not indeed exclusively by applying the so-called "common law control" test as the criterion. This was clearly wrong, in view of the Court's present ruling. But for its action in drawing the ultimate and largely factual conclusion on that basis, the error would require remanding the causes to the District

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forced, would go far to establish an employer-employee relationship . . . ." 156 F. 2d 412, 415. However, it found another factor conclusive: "While many factors in this case indicate such control as to give rise to that relationship, we think the most vital one is missing because of the complete control of the truckmen as to how many, if any, and what helpers they make use of in their operations." 156 F. 2d at 416. Apparently not control of the method of performing the work in general but absence of expressly reserved right of control in a single feature became the criterion used.

Courts in order for them to exercise that function in the light of the present decision.

I would follow that course, so far as the truckers are concerned.

FOOTNOTE 3

96TH CONGRESS
1ST SESSION

H. R. 5266

IN THE HOUSE OF REPRESENTATIVES

Mr. PHILIP M. CRANE introduced the following bill; which was referred to the Committee on Ways and Means.

A BILL

To amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are self-employed for purposes of the employment taxes.

1 Be it enacted by the Senate and House of Representatives
2 of the United States of America in Congress assembled,

1 SHORT TITLE

2 SECTION 1. This Act may be cited as the ''Self-Employed
3 Tax Status Clarification Act of 1979''.

4 STANDARDS

5 SEC. 2. (a) IN GENERAL.--Chapter 25 of the Internal
6 Revenue Code of 1954 (relating to general provisions
7 relating to the employment taxes) is amended by adding at
8 the end thereof the following new section:

9 ''SEC. 3508. ALTERNATIVE STANDARDS FOR DETERMINING WHETHER
10 INDIVIDUALS ARE NOT EMPLOYEES.

11 ''(a) GENERAL RULE.--For purposes of this subtitle other
12 than chapter 22 and for purposes of chapter 2, and
13 notwithstanding any other provision of chapters 21, 23, and
14 24 of this subtitle, if all of the requirements of
15 subsection (b), (c), or (d) are met with respect to service
16 performed by any individual--

17 ''(1) such service shall be treated as being
18 performed by an individual who is not an employee, and

19 ''(2) the person for whom such service is performed
20 shall not be treated as an employer with respect to such
21 service.

22 ''(b) SUBSECTION (b) REQUIREMENT.--For purposes of
23 subsection (a), the requirements of this subsection are met
24 with respect to service performed by any individual if--

25 ''(1) CONTROL OF HOURS WORKED.--The individual

1 controls the aggregate number of hours actually worked
2 and substantially all of the scheduling of the hours
3 worked.
4 ''(2) PLACE OF BUSINESS.--The individual does not
5 maintain a principal place of business, or, if he does
6 so, his principal place of business is not provided by
7 the person for whom such service is performed, or, if it
8 is so provided, the individual pays such person rent
9 therefor. For purposes of this paragraph, the individual
10 shall be deemed not to have a principal place of
11 business if he does not perform substantially all the
12 service at a single fixed location.
13 ''(3) INVESTMENT OR INCOME FLUCTUATION.--
14 ''(A) The individual has a substantial
15 investment in assets used in connection with the
16 performance of the service, or
17 ''(B) The individual risks income fluctuations
18 because his remuneration with respect to such
19 service is directly related to sales or other output
20 rather than to the number of hours actually worked.
21 ''(4) WRITTEN CONTRACT AND NOTICE OF TAX
22 RESPONSIBILITIES.--
23 ''(A) The individual performs the service
24 pursuant to a written contract between the
25 individual and the person for whom such service is

1 performed--

2 ''(i) which was entered into before the

3 performance of the service, and

4 ''(ii) which provides that the individual

5 will not be treated as an employee with respect

6 to such service for purposes of the Federal

7 Insurance Contributions Act, the Social Security

8 Act, the Federal Unemployment Tax Act, and

9 income tax withholding at source; and

10 ''(B) The individual is provided written notice,

11 in such contract or at the time such contract is

12 executed, of his responsibility with respect to the

13 payment of self-employment and Federal income taxes.

14 ''(5) FILING OF REQUIRED RETURNS.--The person for

15 whom such service is performed files any information

16 returns required in respect of such service under

17 section 6041(a).

18 ''(c) SUBSECTION (c) REQUIREMENT.--For purposes of

19 subsection (a), the requirements of this subsection are met

20 with respect to service performed by any individual if--

21 ''(1) INVESTMENT IN ASSETS.--The individual has a

22 substantial investment in the assets used to perform

23 such service.

24 ''(2) OWNERSHIP OR LEASE OF ASSETS.--The individual

25 owns the assets, or holds them under a bona fide lease

1 agreement.

2 ''(3) MAINTENANCE OF ASSETS.--The individual is
3 responsible for the maintenance of the assets.

4 ''(4) INCIDENCE OF COSTS.--The individual bears the
5 principal burden of the operating costs of the assets,
6 including fuel, repairs, supplies, insurance, and
7 personal expenses while engaged in the performance of
8 the service.

9 ''(5) RESPONSIBILITY FOR PERSONAL SERVICES.--The
10 individual is responsible for supplying the personal
11 services necessary in performance of the business.

12 ''(6) CONTRACT.--The individual performs such
13 service pursuant to a written or oral contract with the
14 person for whom such service is performed.

15 ''(7) RETURNS.--Failure by an individual to file any
16 return with respect to remuneration received for the
17 service involved, unless such failure is willful or
18 intentional, shall not affect the application of this
19 subsection to such individual.

20 ''(d) SUBSECTION (d) REQUIREMENT.--For purposes of
21 subsection (a), the requirements of this subsection are met
22 with respect to service performed by any individual in any
23 taxable year if--

24 ''(1) such individual performed similar services for
25 5 or more payors during the preceding calendar year, or

1 ''(2) objective circumstances indicate that such
2 individual can reasonably expect to perform services for
3 5 or more payors during the taxable year.
4 ''(e) SPECIAL RULES.--
5 ''(1) SECTION NOT TO APPLY TO CERTAIN INDIVIDUALS
6 FOR PURPOSES OF SOCIAL SECURITY TAXES.--For purposes of
7 chapters 2 and 21, this section shall not apply to an
8 individual described in section 3121(d)(3) (relating to
9 certain agent-drivers, commission-drivers, full-time
10 life insurance salesmen, home workers, and traveling or
11 city salesmen).
12 ''(2) SPECIAL RULE FOR CONTRACTS ENTERED INTO BEFORE
13 1981.--With respect to contracts entered into before
14 January 1, 1981, subsection (b)(4) of this section shall
15 be deemed to be satisfied if such contract clearly
16 indicates that the individual is not an employee (either
17 by specifying that the individual is an independent
18 contractor or otherwise), provided that the notice
19 required by subsection (b)(4)(B) is given before January
20 1, 1981.
21 ''(f) NO INFERENCE.--If all the requirements of
22 subsection (b), (c), or (d) are not met with respect to any
23 service--
24 ''(1) nothing in this section shall be construed to
25 infer that the service is performed by an employee or

1 that the person for whom the service is performed is an
2 employer, and
3 ''(2) any determination of such an issue shall be
4 made as if this section had not been enacted.''
5 (b) CLERICAL AMENDMENT.--The table of sections for such
6 chapter 25 is amended by adding at the end thereof the
7 following new item:

''Sec. 3508. Alternative standards for determining whether individuals are not employees.''

8 SOCIAL SECURITY COVERAGE

9 SEC. 3. (a) Section 210(a) of the Social Security Act is
10 amended by striking out ''or'' at the end of paragraph (19),
11 by striking out the period at the end of paragraph (20) and
12 inserting in lieu thereof ''; or'', and by adding after
13 paragraph (20) the following new paragraph:
14 ''(21) Service which, under section 3508 of the Internal
15 Revenue Code of 1954, is treated as being performed by an
16 individual who is not an employee.''.
17 (b) Section 3121(b) of the Internal Revenue Code of 1954
18 (relating to definition of employment) is amended by
19 striking out ''or'' at the end of paragraph (19), by
20 striking out the period at the end of paragraph (20) and
21 inserting in lieu thereof ''; or'', and by adding after
22 paragraph (20) the following new paragraph:
23 ''(21) service which, under section 3508, is treated

1 as being performed by an individual who is not an
2 employee.''.
3 REPORT
4 SEC. 4. Not later than January 1, 1984, the Secretary of
5 the Treasury shall prepare and submit to the Committee on
6 Ways and Means of the House of Representatives and the
7 Committee on Finance of the Senate a report on the
8 compliance of individuals who are not treated as employees
9 by reason of the amendments made by this Act with reporting
10 of income and payment of tax requirements under chapters 1
11 and 2 of the Internal Revenue Code of 1954.
12 EFFECTIVE DATE
13 SEC. 5. (a) Except as provided in subsection (b), the
14 amendments made by this Act shall apply to service performed
15 after December 31, 1979.
16 (b) Subsection (b) of section 3508 of the Internal
17 Revenue Code of 1954 (as added by this Act) shall not apply
18 to any attempt after December 31, 1979, to change the
19 employment status of an individual from status as an
20 employee to status as an independent contractor.

FOOTNOTE 4

[¶ 10,215] **Associated General Contractors of California, Inc. et al., Petitioners v. National Labor Relations Board, Respondent and Joint Council of Teamsters, No. 42 et al., Intervenors.**

United States Court of Appeals, Ninth Circuit. Nos. 75-3157, 75-3370, 75-3580. October 11, 1977.

Petition for Review and Cross-Application for Enforcement of a Decision of the National Labor Relations Board.

National Labor Relations Act

Judicial Review—Representation Determination—Preelection Unfair Labor Practice. —Although, by itself, an NLRB representation determination that truck owner-operators were employees was not subject to judicial review, a federal appeals court could review the issue in connection with a complaint that general contractors had unlawfully entered into new contracts covering owner-operators prior to a scheduled decertification election. Since there was no order predicated on the results of an election, the matter was not reviewable under Section 9(d) of the Act. However, the court did have jurisdiction under Section 10(f) to review the issue in order to determine whether or not an unfair labor practice had occurred. The court could not reverse the Board's decision in the representation case to include the owner-operators on the election ballot. NLRA, Sections 9(d) and 10(f). Back references.—¶ 2590.053 and .22.

Independent Contractors—Owner-Drivers—Freedom to Contract.—Dump truck owner-operators were independent contractors rather than employees of general contractors. The total factual context and all incidents of the relationship must be assessed and

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[1] 29 U. S. C. § 159(c)(4) provides as follows: Nothing in this section shall be construed to prohibit the waiving of hearings by stipulation for the purpose of a consent election in conformity with regulations and rules of decision of the Board.

[2] We recognize that there is case law holding that the Board may not alter a bargaining unit that was established by a stipulation between parties. See, e. g., *NLRB v. Detective Intelligence Service, Inc.*, [66 LC ¶ 12,0.03] 448 F. 2d 1022 (9th Cir. 1971); *Tidewater Oil Co. v. NLRB*, [53 LC ¶ 11,153] 358 F. 2d 363, 365 (2d Cir. 1966). However, the Board has authority to interpret a stipulation which it finds ambiguous. *NLRB v. Detective Intelligence Service, Inc., supra*, 448 F. 2d at 1025

Moreover, we note in passing that those cases, holding the Board had no discretion to alter an unambiguous unit created by stipulation, came up for review after an unfair labor practice finding by the Board. We are aware of no case which has used the *Kyne* exception to provide for direct judicial review in these circumstances, and we decline any opportunity to expand this exception beyond its intentionally narrow confines.

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weighed, and no one factor is decisive. The individuals were skilled operators who invested substantial sums in their equipment and who bore the risk of loss. They were free to reject hauling contracts; they did not have continuing relationships with contractors; they could hire substitutes and subcontracts; and their hourly pay reflected the use of the equipment as well as the value of their labor. The contractors' control of loading and dumping sites, route instructions, use of load checkers, and reprimands for standing around did not establish a right to control the manner or means of doing the work. NLRA, Section 2(3). Back reference.—¶ 1650.3571.

Denying enforcement of (1975) 220 NLRB—(No. 93), 1975-76 CCH NLRB ¶ 16,295. See also (1973) 201 NLRB—(No. 36), 1973 CCH NLRB ¶ 24,971.

John H. Stephens (Cox, Castle & Weeks), for Petitioner Associated General Contractors of California. Kenneth N. Silber (Brundage, Beeson, Tayer & Kovach), for Petitioners Teamsters, Locals 137, 150 and others. Alvin Slaight, Jr. (Paul, Hastings & Janofsky), for Petitioner Associated Independent Owner-Operators. Carol Dedeo, for Respondent. William C. Nottger, Jr. (Brundage, Beeson, & Pappy), for Intervenors Joint Council of Teamsters, No. 42.

Before BARNES and SNEED, Circuit Judges and WONG,* District Judge.

[*Statement of Case*]

SNEED, C. J.: Associated General Contractors of California, Inc. (AGC), Building Industry Association of California, Inc. (BIA), and Engineering and Grading Contractors Association, Inc. (EGCA) (jointly referred to as "Employers"), Teamsters Local Union No. 137, et al. (Northern California Unions), and the Associated Independent Owner-Operators, Inc. (AIOO), petition this court under section 10(f) of the National Labor Relations Act, 29 U. S. C. § 160(f) (Act) to review a decision and order of the National Labor Relations Board (Board). The Joint Council of Teamsters No. 42, *et al.*, (Southern California Unions) and the California Dump Truck Owners Association (CDTOA) have intervened, and the Board has filed a cross-application for enforcement. In the decision and order, the Board found that the Employers had engaged in unfair labor practices within the meaning of sections 8(a)(1) and (2) of the Act, 29 U. S. C. §§ 158(a)(1) and (2),[1] by entering into, maintaining and enforcing contracts with the Unions at a time when a real question concerning the representation of the employees existed. It is reported at [1975-76 CCH NLRB ¶ 16,295] 220 NLRB 93.

I. Facts

The AGC, BIA and EGCA are voluntary associations of employers engaged in the building and construction industry. They represent their employer-members in negotiating and administering collective bargaining agreements; all three represent employers in their negotiations with the Southern California Unions and the AGC and EGCA represent employers in negotiations with the Northern California Unions.

The Employers use dump trucks and other vehicles in the course of their construction businesses. These vehicles are operated either by driver-employees, who are employed in the traditional sense and who are represented by the Union,[2] or owner-operators, who are represented by the AIOO and the CDTOA. The fundamental issue around which this litigation swirls is whether these owner-operators should be classified as self-employed independent contractors or employees of the Employers.[3]

Prior to 1971, the Master Labor Agreement (MLA) negotiated by the Employers and the Unions did not cover owner-operators. In 1970, the Unions obtained a modification of the MLA, which was executed

* Honorable Dick Yin Wong, United States District Judge for the District of Hawaii, sitting by designation.

[1] Sections 8(a)(1) and (2) provide that

(a) It shall be an unfair labor practice for an employer—

(1) To interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 157 of this title;

(2) To dominate or interfere with the formation or administration of any labor organization or contribute financial or other support to it: *Provided*, That subject to rules and regulations made and published by the Board pursuant to section 156 of this title, an employer shall not be prohibited from permitting employees to confer with him during working hours without loss of time or pay.

[2] The status of these driver-employees is not at issue, nor is their representation by the Unions questioned.

[3] Neither the parties nor this litigation is a newcomer to this Court. The AIOO previously challenged in district court the Board's finding with respect to the employment status of the owner-operators and attempted to have the election enjoined. The district court dismissed the case for lack of jurisdiction and we affirmed *Hays v. Miller*, [77 LC ¶ 11,121] 524 F. 2d 631 (9th Cir. 1975).

in January, 1971, that would subject the owner-operators to Union control by expanding the coverage of the MLA to include owner-operators as employees. This modification prompted three owner-operators to file decertification petitions with the Board on February 26, 1971, seeking elections in their respective bargaining units and decertification of the incumbent Unions as sole bargaining representatives of construction industry employees.

The Board held hearings on these decertification petitions in which the parties presented conflicting contentions as to the status of the owner-operators. On January 17, 1973, the Board rendered its decision in which it held that the owner-operators were "employees" within the meaning of the Act, that they were entitled to participate in an election, and that a question concerning the representation of the employees existed. [1973 CCH NLRB ¶ 24,971] 201 NLRB 311. The Board also remanded the cases to the Regional Director to determine the scope of the bargaining units and the eligibility of the employees. After hearings on these issues, on March 5, 1974 the Board issued a Supplemental Decision and Direction of Election, which held, *inter alia* that owner-operators were properly included with driver-employees in the same bargaining unit and which directed elections by mail in the separate Northern and Southern California units. [1974 CCH NLRB ¶ 26,276, 26,277] 209 NLRB Nos. 61, 62.

In July 1974, in the midst of election proceedings in the northern and southern regions, the Employers entered into new collective bargaining agreements, which covered the owner-operators, with the Unions. Almost immediately thereafter, the owner-operator associations, the AIOO and the CDTOA, filed unfair labor practice charges against the Employers. The Board suspended further processing of the elections pending the determination of the unfair labor practice charges.[4]

The Board consolidated these charges and held hearings in January, 1975. In September, 1975 the Board rendered the decision now on appeal, finding violations of sections 8(a)(1) and (2) and ordering, *inter alia*, the Employers to cease and desist from further bargaining with the Unions and from enforcing the 1974 contract until the Unions proved their majority representation status in a Board conducted election.

II. The Contentions

The parties bring several issues to this court for review. The first, not surprisingly, deals with the problem of whether the owner-operators are independent contractors or employees. This issue, however, divides itself into two parts: first, whether this court may even reach the issue at this stage and second, whether the Board properly classified the owner-operators as employees. The Employers and the owner-operators here join forces and contend that this court may consider the issue in its review of the unfair labor practice charge and that this court should reverse the Board's finding as to the status of the owner-operators. Inasmuch as this finding underlies the unfair labor practice charge, the Employers and owner-operators seek a remand of the unfair labor charge to the Board. On the other hand, the Board and the Unions insist that this court may not reach the issue because the finding was made in the course of a representation investigation under section 9(c), 29 U. S. C. § 159(c).

The second issue presented by the parties is whether, assuming the owner-operators were properly classified as employees, the evidence was sufficient to support the Board's finding that a real question existed concerning the representation of the majority of the employees. On this issue, the owner-operators align themselves with the Board in support of the Board's finding, whereas the Employers and the Unions stand shoulder to shoulder and argue that the evidence did not support such a finding.

The AIOO also complains of the Board's remedy for the unfair labor practice. It argues that its members are entitled to recover certain losses incurred as a result of the Employers' entering into collective bargaining agreements with the Unions. In addition, it contends that the Board should not have permitted the Employers to continue to recognize the Unions as representatives of the employees.

For the reasons hereafter stated, we hold that appellate review of the issue of the employment status of the owner-operation is proper under the circumstances of this case and we conclude that under the facts

[4] In the southern region, the Board had prepared eligibility lists and had mailed the ballots to the eligible voters. In the northern region, eligibility lists were being prepared. Upon the filing of the unfair labor practice charges, the Board impounded all the votes it had received and discontinued any further proceedings in the elections.

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before us, the owner-operators appropriately should be classified as independent contractors, not employees. This holding makes it unnecessary to reach the remaining issues. We deny enforcement of the Board's order and remand the cases to the Board for further consideration of the unfair labor practice charges in the light of this opinion.

III. Availability of Appellate Review

The parties focus their respective arguments as to whether this court may review the Board's finding with respect to the employment status of the owner-operators on the proper interpretation of section 9(d) of the Act, 29 U. S. C. § 159(d), which provides

> (d) Whenever an order of the Board made pursuant to section 160(c) of this title is based in whole or in part upon facts certified following an investigation pursuant to subsection (c) of this section and there is a petition for the enforcement or review of such order, such certification and the record of such investigation shall be included in the transcript of the entire record required to be filed under subsection (e) or (f) of section 160 of this title, and thereupon the decree of the court enforcing, modifying, or setting aside in whole or in part the order of the Board shall be made and entered upon the pleadings, testimony, and proceedings set forth in such transcript.

The Board contends that this section permits review of rulings made by the Board in representation proceedings only after the Board has (1) held an election, (2) certified the results and (3) ordered the employer to do something based on these election results. It relies heavily on the Supreme Court's decision in *Boire v. Greyhound Corp.*, [49 LC ¶ 18,830] 376 U. S. 473, 84 S. Ct. 894, 11 L. Ed. 2d 849 (1964), where the Court observed "the purpose of § 9(d) was to provide 'for review in the courts only after the election has been held and the Board has ordered the employer to do something predicated upon the results of the election.'" *Id* at 478-79, 84 S. Ct. at 897-98. Inasmuch as the three prerequisites to appeal have not been satisfied, the Board argues, this court may not review the Board's finding. The owner-operators, however, insist on what they consider to be a more practical application of section 9(d). They contend that because the record of the representation case is included in the record of this unfair labor practice case[*] and was the basis for the finding that an unfair labor practice had been committed, section 9(d) is satisfied and this court may consider the matter. While conceding that review of findings in representation proceedings generally are reviewable in the context of a review of an unfair labor charge based on a refusal to bargain with a certified bargaining representation under section 8(a)(5), 29 U. S. C. § 158(a)(5), the owner-operators argue that such findings are also reviewable in the course of a review of other unfair labor practice charges, such as the sections 8(a)(1) and (2) charges in these cases.

[Indirect Review]

We agree with the Board in that section 9(d) in itself does not allow us to review this ruling of the Board. Nonetheless, we conclude that we may review the Board's finding, under section 10(f), 29 U. S. C. § 160(f), in conjunction with our review of the unfair labor practice charges now before us, and that this review is not precluded by section 9(d).

The legislative history of section 9(d) supports our reasoning. Prior to the enactment of section 9(d) in 1935, direct review of election orders prior to the election was permitted. This allowed employers to engage in dilatory tactics aimed at weakening the position of the unions, whose influence tended to wane as the election was postponed pending court review. See 79 Cong. Rec. 7569 (1935) (remarks of Sen. Wagner). To remedy this defect, Congress passed section 9(d). By its enactment, Congress intended to abolish direct review of the representation findings, replacing it with a method of indirect review whereby an employer faced with a Board order relating to an unfair labor practice based on the results of an election could obtain review of the underlying representation proceeding indirectly through the review of the unfair labor practice decision. It is clear that Congress did not contemplate direct review of representation proceedings prior to an election. S. Rep. No. 573-74, 74th Cong., 1st Sess., 14 (1935). See *Boire v. Greyhound Corp., supra; A. F. of L. v. NLRB.*, [2 LC ¶ 17,051] 308 U. S. 401, 60 S. Ct. 300, 84 L. Ed. 347 (1940). Instead, Congress struck a balance which would prevent undue interference with the election process with its attendant detrimental effect on labor relations but which also would pro-

[*] The parties introduced the record of the representation case into evidence at the hearing below, and it is a part of the record before us.

vide for eventual review of the representation proceedings. See H. R. Rep. No. 969, 74th Cong., 1st Sess., 5, 20-21 (1935) H. R. Rep. No. 972, 74th Cong., 1st Sess., 5-6, 20-21 (1935).

Congress reaffirmed its belief in this balance during the passage of the Labor Management Relations Act of 1947. The House proposed an amendment to section 10(f) which would allow "any person aggrieved by a final order of the Board [including an order of certification under section 9]" to appeal. This amendment sought to cure the unfairness of the present system, in which many of the parties are without an effective avenue of appeal, by giving any aggrieved person the right to a direct appeal from the election order.[8] The amendment was rejected because it would permit the same dilatory tactics used prior to 1935. 93 Cong. Rec. 644 (1947) (remarks of Sen. Taft).

In sum, the intended thrust of section 9(d) was aimed at the prohibition of *direct* review of certification orders; *indirect* review at some point was clearly envisioned. Taken in this context, comments such as "Section 9(d) makes it absolutely clear that there shall be no right to court review anterior to the holding of an election," S. Rep. No. 573, 74th Cong., 1st Sess., 14 (1935) must be viewed as merely restating the intention of Congress to deny *direct* review of certification orders. It does not follow that indirect review of representation proceedings prior to an election is prohibited.

NLRB v. Falk Corp, [2 LC ¶ 17,053] 308 U. S. 453, 60 S. Ct. 307, 84 L. Ed. 396 (1940), is not to the contrary. In that case, the Board, in a consolidated proceeding, (1) had found that the employer had committed an unfair labor practice by fostering and dominating a company union and (2) had directed an election to be held without the participation of the company union. The court of appeals granted enforcement of the Board's order to cease dominating and to disestablish the company union. However, on its own volition, it ordered that the employees in a future election should be free to choose the company union. The Supreme Court primarily was concerned with only the latter holding.

The Court held that section 9(d) did not authorize "such anticipatory judicial control of election methods." Inasmuch as none of the Board's orders was "'based in whole or in part upon facts certified' as the result of an election," *NLRB v. Falk Corp.*, 308 U. S. at 459, 60 S. Ct. at 311, the court of appeals was powerless to modify the election proceeding. The Court limited the power of the court of appeals under section 9(d) to review of Board orders based on an actual certification of a bargaining representative.

> The proposed election here has not even been held and consequently no certification of a proper bargaining agent has been made by the Board. Until that election is held, there can be no certification of a bargaining representative and no Board order—based on a certification, has been or can be made, so as to invoke the court's powers under 9(d).

NLRB v. Falk Corp., 308 U. S. at 459, 60 S. Ct. at 311.

Under the Court's reasoning (contrary to the owner-operators contention at oral argument) "facts certified" are limited to those actually certified after an election, *viz.*, the certification of the bargaining unit, bargaining representative, etc., and do not include any facts which the Board may "certify" as part of the record. The Court spoke unequivocally when it said:

> There can be no court review under 9(d) until the Board issues an order and requires the employer to do something predicated upon the result of an election.
>
> Since this employer has not been ordered by the Board to do anything predicated upon the results of an election the court had no authority to act under 9(d).

Id.

[*Unlawful Assistance Charge*]

Although section 9(d) provides no authority to consider the owner-operator issue, it also does not preclude reaching the issue in the context of the independent unfair labor practice under section 10(f). The basis for this conclusion resides in *Falk*. The pivotal finding there was that the employer fostered and dominated the company union. This finding provided the basis for the Board's unfair labor practice holding, which holding was reviewed by the court of appeals in the course of deciding that the Board's order to cease dominating and to disestablish the company union should be enforced. The Supreme Court

[8] This [the current] procedure is unfair to everyone; the Union that wins, which frequently must wait for months to exercise its rights; the union that loses, which has no appeal at all no matter how wrong the certification may be; the employees, who have no appeal; and the employer, for whom an appeal involves great risks.
H. R. No. 245, 80th Cong., 1st Sess., 43 (1947).

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recognized that the court of appeals had jurisdiction to review the Board's unfair labor practice holding and in the course of which, to determine whether the Board correctly found that the employer fostered and dominated the company union. Had it not so recognized jurisdiction it would have pointed out that the circuit court's enforcement of the unfair labor practice order was a *brutum fulmen*. No such indication was given. Moreover, nothing in *Falk* indicates that the circuit court's power was limited to enforcement only.

Here, the pivotal finding by the Board was that owner-operators are employees. This finding was the basis for conducting an election in which the bargaining unit included owner-operators. It also was the basis for the unfair labor practice of bargaining with a union when a question concerning representation exists. In reviewing the Board's unfair labor practice holding under the authority of section 10(f) we must determine whether the Board correctly held the owner-operators to be employees. In doing so we are merely doing what the court of appeals in *Falk* did when it reviewed the facts and enforced the Board's order to cease dominating and to disestablish the company union.[7] Our jurisdiction, however, is limited to the unfair labor practice proceedings. Under *Falk*, we have no jurisdiction to review any order in connection with the representation proceedings.[8]

Holding as we have that in the context of the unfair labor practice charge we may consider the issue of whether the owner-operators are properly considered employees or independent contractors, we now turn to the merits of this problem.

IV. Reversal of the Board's Finding

The facts relating to the independent contractor-employee controversy are not in question. We need only determine (1) whether the Board employed the correct legal standard in deciding this question and (2) if so, was this legal standard properly applied.

For the purposes of section 2(3) of the Act, 29 U. S. C. § 152(3), the term "employee" does not include "any individual having the status of an independent contractor." In distinguishing between the two, both the Board and the courts must apply general agency principles, *NLRB v. United Insurance Co.*, [57 LC ¶ 12,520] 390 U. S. 254, 256, 88 S. Ct. 988, 19 L. Ed. 2d 1083 (1968), such as those found in the *Restatement (Second) of Agency* § 220(2) (1957). *Associated Independent Owner-Operators, Inc. v. NLRB*, [59 LC ¶ 13,285] 407 F. 2d 1383 (9 Cir. 1969). Of the considerations employed in reaching a decision under general agency law, the determination of who has the right to control and direct the work is foremost. *SIDA of Hawaii, Inc. v. NLRB*, [76 LC ¶ 10,222] 512 F. 2d 354 (9th Cir. 1975); *Associated Independent Owner-Operators, Inc. v. NLRB, supra.* It must be tempered, however, by other considerations relevant to the relationship in its entirely. *NLRB v. United Insurance Co.*,

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[7] The case before us admittedly is distinguishable from *Falk* in terms of the chronology of events. In *Falk*, the two proceedings were held simultaneously, whereas in our case the representation case preceded the unfair labor case. This is a distinction without a diffrence. To illustrate, assume that in *Falk*, the representation case was heard first, and the Board found that the employer had fostered and dominated the company union and therefore the Board would not place the company union's name on the ballot. Then, because of this finding, an unfair labor practice charge was heard, relying mainly on the earlier finding in the representation proceeding. To allow this procedural difference to deprive this court of the power to reach the controlling issue in this case places form over substance.

We do note one other difference. In the instan' case, it was the employers' action taken after he Board's finding that precipitated the unfair labor practice charge. In *Falk*, the employer's actions preceded both the representation proceeding and the unfair labor practice proceeding. This difference should not change the result because it is not relevant to the issue before us, to wit, whether this court may consider a finding made in a representation proceeding in the course of its review of an unfair labor practice charge when the representation proceeding is incorporated into the unfair labor practice proceeding.

[8] To illustrate further, we turn to the Fourth Circuit decision in *E. I. Dupont De Nemours & Co. v NLRB*, [3 LC ¶ 60,204] 116 F. 2d 388 (4th Cir. 1940), which relies heavily on *Falk*. As in *Falk*, the Board, in consolidated unfair labor practice and representation proceedings, had found that the employer had committed an unfair labor practice by dominating a company union and therefore the Board excluded the company union from the ballot. The court of appeals reversed the Board on the unfair labor practice issue, finding that the employer had not interfered with the formation or operation of the company union. Under *Falk*, however, it held that it could not review the finding as it related to the representation proceeding and consequently could not reverse the Board decision to exclude the company union from the ballot. Similarly, we may not reverse the Board decision in the representation proceeding with respect to the inclusion of the owner-operators in the bargaining unit on the basis of our decision herein. Nevertheless, we may reverse the Board with respect to the owner-operator question as it relates to the unfair labor practice charges now before us.

supra. Although the Board applied this "right-of-control" test, we disagree with its application of the test and its apparent failure to give sufficient weight to other indicia of independent contractor status.

Yet simple disagreement with the Board does not mandate reversal. We may not reverse the Board simply because we might have decided the case differently were it tried before us *de novo*, *NLRB v. United Insurance Co*, *supra*, nor may we if the board has chosen between two fairly conflicting views of the issue. *NLRB v. United Insurance Co*, *supra*; *SIDA of Hawaii, Inc. v. NLRB*, *supra*; *Associated Independent Owner-Operators, Inc. v. NLRB*, *supra*. On the other hand, if the Board decision that the owner-operators are employees lacks substantial support in the record considered as a whole, we must reverse. Inasmuch as the determination of this issue will depend on the particular facts of the case, we shall first describe the factual setting before us.[9]

The owner-operators own and operate dump trucks and perform hauling services for contractors. They deal either directly with the contractor or through an overlying carrier, who contracts with the contractor to provide hauling services and in turn subcontracts his work to the owner-operators for a fee of 5% of the minimum tariff for the work. An owner-operator generally will have such subcontractual, or subhaul, agreements with various overlying carriers; conversely, an overlying carrier will have subhaul agreements with various owner-operators. The overlying carriers do not supervise in any significant fashion the work of the owner-operators. Rejection of referrals from overlying carriers is common; an owner-operator often will turn down work he believes is too dangerous, unprofitable or simply does not fit into his schedule.

The relationship between an owner-operator and a contractor generally is short-lived. An owner-operator may work for as many as 100 contractors in any given year, and sometimes will work for two different contractors during the course of one work day.

The California Public Utilities Commission (PUC) establishes the minimum tariff, which includes compensation for both labor and equipment. Owner-operators are free to negotiate for higher rates; the minimum tariff operates as a floor below which the rates may not fall. Owner-operators are usually paid by the hour, although sometimes their pay is based on mileage and tonnage rates. Unlike employee-drivers, who are paid on an hourly basis from the time they are told to report to work until the work day is finished, regardless of whether the equipment is in operation throughout that period, owner-operators are not paid for the time their equipment is inactive. Moreover, the contractors do not deduct state and federal income tax, social security, or disability insurance from the owner-operators' wages. The owner-operator keeps track of his own time and presents a bill for his services to the contractor or overlying carrier. This is then compared against the records kept by the contractor or overlying carrier to prevent padding of the bill.

Under the regulations of the PUC, the owner-operators must obtain a permit issued by the PUC, be bonded, and carry sufficient liability insurance. In addition, owner-operators are responsible for any traffic violations for overloading and spillage.

An owner-operator bears the entire cost of his enterprise. This usually includes his trucking equipment ($15,000 to $20,000), a service pick-up ($1,000 to $4,000), tools ($500 to $1,500), insurance premiums ($500 to $3,500), and office supplies, including for example, stationery, invoices, a typewriter and a calculating machine. In addition he must pay all maintenance and operational expenses.

An owner-operator may hire a driver to operate his equipment, in which case he pays the driver an hourly wage and makes the standard deductions from the driver's pay. He may also subcontract the work to another owner-operator. In either case, he need not first receive permission for such substitution from nor even report the substitution to the contractor. If he hires a driver, this driver is under the exclusive control of the owner-operator.

At the jobsite, the owner-operators follow the same starting time, quitting time and lunch break as do employee-drivers. In most cases, the contractors direct the owner-operators where to load and to dump the materials and designate the routes to be taken. Contractors may have personnel, known as "load checkers," who oversee the performance of the owner-operators. Contractors also often have "spotters" who tell the owner-operators where to dump the material. On occasion, contractors take

[9] These facts are derived from the Board's decision in the underlying representation case, reported at 201 NLRB 311.

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disciplinary actions in the form of reprimands or docking pay for an owner-operator's poor performance.

In determining that the owner-operators are employees, the Board seized on several facts relating to the owner-operators' performance of their work at the jobsite and concluded that these facts indicated that the contractors had the right to control the manner and means by which the desired result was accomplished and therefore the relationship between the parties was that of employer-employee. In so concluding, the Board, although recognizing the distinction between the right to control the manner and means and the right to control only the result, failed to draw properly this distinction. Moreover, the factors relied upon by the Board are not persuasive evidence of an employer-employee relationship.

[*Contractor's Control*]

The contractor's control of the loading and dumping sites and instructions to the owner-operators as to where to pick up and dump this material demonstrates the contractor's right to control the *result* of the work, not the *manner* or *means* of doing the work. Such instructions have little to do with the actual operation of the equipment, *viz.* the manner in which material is loaded, unloaded, and transported. See *Associated Industrial Owner Operators, Inc. v. NLRB, supra.* Nor does designation of the routes to be taken necessarily indicate that the contractors controlled the manner and means of accomplishing the desired result. Inasmuch as the owner-operators are paid by either the hour or by the mile, it certainly is in the contractor's best interest not to permit owner-operators to take circuitous routes to and from the jobsite. Control of this facet of the business merely prevents padding of the ultimate cost. In the same vein, neither the presence of load checkers, who make certain that the dump trucks do not take side trips, nor spotters, who direct the owner-operators where to dump the material, deprives the owner-operators of their independent status. The existence of the load checkers is simply a by-product of the method of payment. The spotters perform a function which involves primarily the final result of the owner-operator's services.

The Board also pointed to the fact that contractors reprimand owner-operators for "standing around and talking, for dumping at a site not designated by the contractor, and for taking excessively long lunch breaks" as an indication of the contractor's control. Clearly the designation of a dumping site is a part of the desired result, which is within the sphere of the contractor's control in an contractor-independent contractor relationship. *Associated Independent Owner-Operators v. NLRB, supra.* As for reprimands for loafing and taking excessively long lunch breaks, these are to be expected from a contractor who wishes to complete a job on time. Such reprimands are not examples of interference with the manner and means by which an owner-operator loads his truck, transports material to a dump site, and unloads his truck.

Finally, the Board notes that the owner-operators are required to observe the same starting and quitting times and lunch breaks as the rest of the employees. Again, this is a necessary requirement by virtue of the need for cooperation among the various workmen of a construction site. Loaders load the dump trucks; the owner-operators must coordinate their work with these loaders. Such coordination would be more difficult if varying lunch hours were observed. We accorded the insignificant factor of prescribed working hours little weight in *Associated Independent Owner-Operators v. NLRB, supra,* and do so again here.

[*Entrepreneurs*]

Looking at the relationship in its entirety, it becomes even clearer that the owner-operators are independent contractors. Each operates an independent business of his own, see Restatement, *supra,* § 220(2)(b), in which the contractors exercise no control. See *Joint Council of Teamsters No. 42 v. NLRB,* [66 LC ¶ 12,075] 146 U. S. App. D. C. 275, 282, 450 F. 2d 1322, 1329 (1971) (MacKinnon, J., dissenting). Each is a skilled operator. *Associated Independent Owner-Operators v. NLRB, supra;* Restatement, *supra,* § 220(2)(d). Being entrepreneurs, each must invest substantial sums in equipment and bear the risk of any loss attributed to his operation. See *SIDA of Hawaii, Inc. v. NLRB, supra; Brown v. NLRB,* [68 LC ¶ 12,787] 462 F. 2d 699 (9th Cir.), *cert denied,* 409 U. S. 1008, 93 S. Ct. 441, 34 L. Ed. 2d 301 (1972). It is the owner-operator's responsibility to meet the regulations of the PUC so that he may operate legally. The success of an owner-operator depends upon his own skill and business acumen, and does not depend on that of any contractor. He may work as little as he wants or as much as he can, and for as many different contractors as will hire him. It is unlikely that he will work for any single contractor for an

extended length of time. See Restatement, *supra* § 220(2)(f). He does not have a continuing relationship with a contractor in the same sense that an employee has a continuing relationship with an employer. His relationship is ongoing only in that he may do some more work for the contractor some time in the future. In short, owner-operators run businesses completely independent of the contractors, and in the main are not subject to their control. The contractors' only real concern is in the accomplishment of the job for which the owner-operators are hired, to wit, the loading, hauling and dumping of material. Any supervisory activity of the contractors is limited to that which is necessary to accomplish this goal. See *Joint Council of Teamsters No. 42 v. NLRB, supra,* (MacKinnon, J., dissenting).

There are other indicia of the independent contractor status of the owner operators. Although paid on an hourly basis, which is usually an indication of employee status, Restatement, *supra* § 220(2)(g), the hourly rate reflects amounts attributed to the use of the equipment as well as to the value of the labor. Thus, owner-operators are not paid for the time they are on the jobsite when their equipment is idle. Moreover, the contractors do not make any of the normal deductions from the pay of the owner-operators, contrary to the practice commonly employed with respect to true employees. Also contrary to the practice used in dealing with employees, each owner-operator is free to reach his own bargain with each contractor as to the amount he is to be paid, limited only by the minimum tariff set by the PUC. We note that all of these considerations were present in *Associated Independent Owner-Operators v. NLRB, supra* where we reversed a Board decision finding owner-operators of graders employees.

In addition, owner-operators may hire substitute drivers or subcontract the work to another owner-operator without prior permission of or any notification to the contractor. This is clearly inconsistent with a finding that a personal employer-employee relationship exists. It is further evidence that the owner-operator's truck is his exclusive domain, and its operation is beyond the authority of the contractor.[10]

In determining whether the owner-operators are employees or independent contractors, the "total factual context" and "all the incidents of the relationship must be assessed and weighed with no one factor being decisive." *NLRB v. United Insurance Co.*, 390 U. S. at 258, 88 S. Ct at 991. This the Board failed to do. Instead, it gave inordinate weight to isolated examples of contractor control at the jobsite, control which in the main involved only the result sought to be accomplished.[11] Given the the exigencies of a construction site, the contractor's reasonable instructions as to trivial matters, such as the timing of the lunch hour, cannot transform what by every other indicia is contractor-independent contractor relationship into an employer-employee relationship. Looking to the "total factual context" of the relationship which the owner-operators and contractors maintain, we hold that the Board erred in concluding that the owner-operators of dump trucks are employees. This holding does not depart from the spirit of our earlier holding in *Associated Independent Owner-Operators, Inc. v. NLRB, supra.*

We deny enforcement of the Board's decision and order of September, 1975 and remand this case to the Board for further proceedings consistent with this opinion.

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[10] We also note that contractors do not give owner-operators any instructions on how to operate the dump trucks, nor do they require that the trucks be of a certain type or be maintained in any certain fashion.

[11] We disagree with the majority in *Joint Council of Teamsters No. 42 v. NLRB*, 146 U. S. App. D. C. 275, 450 F. 2d 1322 (1971), which held that the owner-operators of dump trucks were employees. That court found that the contractors did exercise sufficient control of the details of the work to outweigh other indicia of independent contractor status. However, we are of the opinion that the D. C. Circuit erred in two respects. First, it failed to consider the relationship as a whole, and second as the Board in the case before us, it was blinded by presence of the contractors' right to control details of the work which were necessary only to insure a smooth running construction job and the accomplishment of the desired result.

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FOOTNOTE 5

One of the most common mistakes made in making employer-employee determinations is that agents do not fully develop their case.

It might be said that in auditing by acception an agent attempts to apply an occupationalized-type ruling to an occupation without developing the common-law factors that show the right to control.

The main factors to be considered are discussed in detail in Chapter 8 of the Social Security Handbook. These are general guides intended to aid in reaching a conclusion and not to compel a particular conclusion. The weight to be given to these factors is not always constant. Their degree of importance may vary, depending on the occupation and the reasons for the factors. Some factors do not apply to certain occupations. Therefore judgment and discretion must be used in applying these guides.

Common law factors that show control or lack of control are:

1. Instructions given
2. Training given
3. Integration
4. Services rendered personally
5. Hiring, supervising and paying assistants
6. Continuing relationship
7. Set hours of work
8. Full time required
9. Doing work on employer's premises
10. Order or sequence set
11. Oral or written reports
12. Payment by hour, week, month and guaranteed minimum salary
13. Payment of worker's business and/or traveling expenses
14. Furnishing tools, material
15. Significant investment
16. Realization of profit or loss
17. Working for more than one firm at same time
18. Making service available to general public
19. Right to discharge
20. Right to terminate

In applying the above factors, each must be considered from two standpoints:

a. Does it exist?
b. What is the reason for its existence or nonexistence

Each of these factors or elements that show control of details of work must be weighed against or compared to those which point to an independent contractor status. Any single fact or small group of facts is not conclusive evidence of the presence or absence of control. It is a combination of these facts which points to an employer-employee relationship or to an independent contractor status.

Above source: IRS Training Manual 3142-03 (5-71)

Senator BYRD. There is a second panel dealing with S. 736. This panel will consist of Mr. Duncan McRae, Jr., executive vice president, Melton Truck Lines on behalf of the American Trucking Institution; Mr. James D. McCarthy, vice president, tax services, for General Business Services, Inc., Washington, D.C., on behalf of the International Franchise Association; Mr. Kenneth S. Rolston, executive vice president, American Pulpwood Association; and Mr. Fred Napolitano, vice president and secretary of the Association of Home Builders of Virginia Beach.

Welcome, gentlemen.

Mr. McRae, would you lead off?

Mr. MCRAE. Yes, sir.

My name is Duncan McRae, Jr., sir. I am with Melton Truck Lines in Shreveport, La. I have submitted a written statement on behalf of the American Trucking Association, and also a separate written statement on behalf of the American Movers Conference, which is an affiliate of ATA, and I would like to have those made a part of the record.

Senator BYRD. That will be made a part of the record.

STATEMENT OF DUNCAN McRAE, JR., EXECUTIVE VICE PRESIDENT, MELTON TRUCK LINES, ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATION

Mr. MCRAE. The American Trucking Association is the national association of the trucking industry. As such, we represent all types of motor carriers of freight, both for hire and private.

Mr. Chairman, we appear today to urge that this subcommittee, and the Congress, continue the historic status of the independent truck operator, as independent businessmen exercising their entrepreneurial spirit and talent. Furthermore, we urge this subcommittee and the Congress not to further strain the limited financial resources of these independent small businessmen by imposing a withholding tax upon their receipts which they so sorely need to meet the great demands imposed upon them by inflation and the fuel crisis, as well as other economic burdens.

The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these independent operators. This dedication comes from the fact that the independent truck operator is an independent businessman in control of his own work habits and, to that extent, in control of his own destiny.

Mr. Chairman, the monthly cash demands imposed upon an independent truck operator are substantial. These demands reflect his cost of investment, maintenance of equipment, operating expenses and, of course, the support of his family. To subject the receipts of these independent small businessmen to as yet an additional substantial expense in the form of a withholding tax without an adequate showing of need for such withholding by the Internal Revenue Service will drive thousands of these entrepreneurs over the brink of financial disaster and out of business, and make it economically unattractive for new entrants, all to the great detriment of the motor carrier industry and the country.

Independent truck operators generally own their own power units. The independent operators control their day-to-day oper-

ations, subject to the regulatory requirements of the Interstate Commerce Commission, the Department of Transportation, and other Federal as well as State agencies.

They are not supervised in their daily routine by the motor carrier. Many independent operators haul freight over long distances across the country. Some may go for many days or weeks with the only contact with the motor carrier being a telephone call to find freight to haul or to advise of a delivery.

Working in cooperation with trucking industry groups the Service, in the early seventies, issued a set of guidelines by which to determine the status of independent truck operators. The guidelines are written so that they can be easily understood and applied by examining agents as well as by motor carriers and independent operators. The guidelines have generally eliminated the turmoil.

The guidelines are substantially similar to the test proposed in the Dole bill, S. 736, and the Gephardt bill, H.R. 3245, and are detailed on pages 10 and 11 of our written statement.

If, and so long, as the Internal Revenue Service applies the guidelines fairly and consistently, there would be no need for legislation insofar as the trucking industry is concerned. Shifting determinations by the Service in other industries are the source of the current problem.

While the Dole bill is essentially the same as the Gephardt bill, it does not contain a no-inference provision. Such a provision is essential. Such a provision is essential to the accomplishment of the bill's goal.

The inclusion of a no-inference provision in any legislation adopted by this subcommittee is strongly supported and urged by the motor carrier industry. In oral and written testimony presented to the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, the Treasury portrayed a picture of widespread noncompliance in the reporting of income and the payment of income and social security taxes by independent contractors.

We have substantial reservations about the validity of the Service's study, arguing that there is a substantial compliance problem. Not only its results, but its methodology as well.

Of significant concern to us is the fact that while the results purport to apply to all independent contractors, the sample from which the study was drawn consisted of those persons whom the Service proposed to reclassify from independent contractors to employees.

We seek to assure that the historical independent contractor status of the motor carriers independent truck operators is preserved. We strongly oppose the Treasury's proposal for a withholding tax on all payments made in the course of a trade or business to an independent contractor for the reasons already noted. Such withholding will surely, we submit, result in the financial ruin of a substantial number of small businessmen. We recommend the enactment of the Gephardt bill, or the Dole bill, if it is amended to include a no-inference provision.

We further urge that the common law be retained, even with the enactment of the "safe harbor" provisions.

Thank you very much.

Senator BYRD. Thank you.

Mr. McCarthy?

STATEMENT OF JAMES D. McCARTHY, VICE PRESIDENT, TAX SERVICES, GENERAL BUSINESS SERVICES, INC., ON BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION

Mr. McCARTHY. Thank you, Mr. Chairman.

My name is Jim McCarthy. I am here today to represent the International Franchise Association.

The IFA is a membership organization of about 380 franchisors, large and small, and is generally recognized as being the spokesperson for the franchising industry. According to recent Department of Commerce statistics, one-third of retail sales in the United States are made by businesses operating franchises.

We wholly support the bill, provided that it is not amended to include the 10-percent withholding provision. You might wonder why a franchisor outfit is concerned with us at all. In the typical francise arrangement, me, as a franchisor, would issue a license to you as a franchisee, to use my trademark and expertise. You, in turn, would pay me a royalty fee for such use. The funds do not flow from me to you; they flow backward.

There have been cases, however, a number of horrifying cases where, through a reverse agency theory, the franchisor has been deemed to be an employer and charges with large amounts of back-due employment taxes.

So in our prepared statement—which I have submitted—there are two cautions that we would like to have read in the record.

In a franchisor arrangement where I indicate to you to keep your store opened *x* number of hours a week or *x* number of days a week, we do not want that inadvertently to spoil one of the safe harbor tests in that we are controlling you, nor do we want one of the safe harbor tests to be spoiled if we require you, as a franchisee, to provide us with reports.

We question the Treasury study. The Treasury study was a list of the various businesses, restaurants, insurance businesses, and so on and at the end it came down to franchises.

Really, franchising is a way of doing business, not a separate industry. There are franchisees who operate restaurants and insurance businesses and real estate businesses. If the study were to be accurate, it should have had restaurants and independently owned franchise operators and so on.

We are stuck with the 50-percent noncompliance rap based on, apparently, 60 audits of franchisors—and again, I repeat, franchises make up one-third of all retail sales of the United States.

We are horrified at the statement made by Treasury representatives that the requirement of withholding by the payor would not have a significant recordkeeping burden. It would. It would add a tremendous cost to the payor and especially affect the small business community who, in our opinion, is being destroyed now with ever-increasing recordkeeping requirements.

We are for the bill, providing it does not have a withholding provision.

Thank you.

Senator BYRD. Thank you.

The next witness will be Mr. Rolston.

STATEMENT OF KENNETH S. ROLSTON, EXECUTIVE VICE PRESIDENT, AMERICAN PULPWOOD ASSOCIATION

Mr. ROLSTON. Thank you, Mr. Chairman. I represent the American Pulpwood Association and, in addition, 44 forestry and logging associations in 32 States which are listed in my formal statement.

If my predecessor thinks 50-percent noncompliance, try 70 percent. We do not believe a bit of it.

You will find our position on the IRS compliance study in our written statement. We have had it analyzed, and we find very seroius problems with it.

On top of it, what we see is that there is really a change in target now. In 1978 when we came in here, it was because the IRS was whipping up on the payors. Now they realize they had a concept that did not work, and there was some remedial legislation. Now it looks like the IRS wants to whip up on the payees, the independent contractors, and change the target.

But in the long run, what will happen here is that, in an effort to kill the fox, the tax evader, they are going to get a lot of chickens in the process.

I think someone in the logging business who has been a responsible taxpayer for many years is going to justifiably get upset if the Government comes and tells him, "Hey now, you are not going to handle things like other companies now. We are going to take the 10 percent out front and handle this for you."

On top of this, you know taxpayers get upset—I do once a year—some small businessmen get upset four times a year, because that is when they have to make advance tax payments—when it actually comes home.

You take that independent contractor out there that may have hundreds of transactions during a year where he gets payments for his services or products. You are going to upset him all the time, everytime that happens, that 10 percent comes out of his payments.

I just do not think it is going to work and I do not think it is credible.

The IRS has the capacity to go out and find these people right now. They have two campaigns on against our industry, 1 in 9 counties in Florida and another in 17 counties in Pennsylvania. They can find the people. The information is there. They just have to go find where the logs are sold and they can go out and find out whether there is tax compliance or not.

That is about it. We support 736 all the way without any substantial amendment.

Senator BYRD. Thank you.

Mr. Napolitano?

STATEMENT OF FRED NAPOLITANO, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. NAPOLITANO. My name is Fred Napolitano. I am a home builder from Virginia Beach, Va. I appear here today on behalf of the National Association of Home Builders of which I am vice president and secretary.

With me today is Mr. Bob Bannister, our senior vice president for governmental affairs and Mr. Leonard Silverstein, our tax counsel for NAHB.

NAHB is the trade association of the housing industry of the United States. Our membership, engaged in the building of the homes of America, comprises more than 118,000 members and more than 700 local associations situated throughout our country.

The membership of NAHB is vitally and directly affected by the concerns which are the subject of S. 736. The ambiguities in present law concerning the distinction between an employee and an independent contractor have long been a source of Internal Revenue Service inquiry of homebuilders. Often, this entails a time-consuming, expensive and, we believe, needless tax audit controversies.

NAHB, therefore, shares fully the concerns of Senator Dole and, for that matter, the Treasury Department in resolving the independent contractor-employee issue. At the same time, this committee must be fully aware of the special needs of the housing industry in relation to these problems.

First, we strenuously oppose the Treasury approach of a 10-percent withholding tax. Any withholding tax simply shifts the cost of compliance from the Revenue Service to the operating homebuilder.

That person typically is a small businessman producing less than 25 homes a year, who engages very few direct employees, often no more than three or four.

The withholding tax approach adds complications and costs to the administration of homebuilding, already overburdened with administrative expenses.

To give you one quick example of that, a builder will give out a contract for labor and material; there is no way of knowing how much is labor, how much is material. Taking 10 percent of the entire contract would not be necessary at that time. We do not know how much of that is labor.

The committee should also be aware that certain tests of S. 736 are somewhat ambiguous when applied to homebuilding operations. Regarding a person's control of his own hours, home construction entails work performed on a job site in sequence by many subcontractors.

Therefore, a builder must necessarily impose time and date limits upon initiation and completion of work of the subcontractor. We urge that these factors not be deemed to cause the subcontractor to be considered as an employee. Nor should a subcontractor be characterized as an employee if, as occurs in homebuilding, most of the work takes place at a single-fixed location, and even though the value of all the assets of a subcontractor, such as small tools or equipment, may be great in relationship to the value of the services.

Finally, a subcontractor, in the performance of his work, may store his equipment on a temporary basis provided by the homebuilder rent free. This factor should not cause the subcontractor to be regarded as having a principal place of business.

I would be happy to answer any questions.

Senator BYRD. Thank you, sir.

Senator Dole?

Senator DOLE. I have no questions. I appreciate the comments. The bill is reasonable. It is supported by a number of Members in the Senate of both parties. It is an effort to establish, once and for all, the status of what many thought of the law all along.

We see the Treasury tinkering with the law from time to time. I appreciate the testimony. If anybody has anything to add—otherwise, I have no questions.

Senator BYRD. Senator Chafee?

Senator CHAFEE. I have no questions.

Senator BYRD. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT OF DUNCAN MCRAE, JR., ON BEHALF OF THE COMMITTEE ON OPERATING PRACTICES OF THE AMERICAN TRUCKING ASSOCIATION, INC.

SUMMARY

I

The independent truck operator is an independent businessman, in control of his own work habits, and to that extent in control of his own destiny.

He is the classic example of the American dream of owning your own business -- working for yourself -- and, therefore, is the prototype small businessman.

He is a vital segment of this country's motor transport system, which depends upon the independent operators' entrepreneurial spirit. Their historic status as independent contractors must continue unimpaired.

The trucking industry has found the common law to be instructive in determining an independent operator's status as an independent contractor. We urge that the common law in this regard not be tampered with.

II

The trucking industry is fully aware of the continued attack by the Internal Revenue Service upon the small businessman's status as an independent contractor. To remove the uncertainties that these attacks have caused we support the legislative effort, exemplified by S. 736 -- the Dole bill, and H.R. 3245 -- the Gephardt bill -- to establish statutory "safe harbor" rules based upon the common law, in addition to retaining the common law.

Any safe harbor tests that are adopted must take account of the operating practices of the trucking industry, particularly those imposed upon the industry by Federal and State laws and regulations.

While we would, obviously, support legislation that would exempt independent operators from all withholding and employment tax provisions, we recognize the inherent problems presented in attempting to resolve the issue with that type of legislation.

III

In the strongest possible terms, we oppose the imposition of any withholding tax on the payments received by independent contractor operators from the motor carriers with whom they contract.

The Treasury Department's proposed withholding is sought because of an alleged serious noncompliance problem. The existence of the alleged noncompliance problem is based upon an Internal Revenue Service study which, we submit, has serious flaws in methodology, as well as in conclusions.

A survey made of a limited number of members of the American Trucking Associations, Inc. supports the conclusion that the independent truck operator _is_ complying with his obligations under the tax laws.

Furthermore, analysis of the Internal Revenue Service study that we have commissioned, while not yet completed, supports the view that the study is seriously flawed. The preliminary reports we have state that the conclusion of the Service study is not supportable because of defects in the sample and the methodology.

Furthermore, the withholding from the independent truck operator of a substantial portion of his gross revenue will, we submit, drive this independent businessman over the brink of financial disaster, and this would be true, even if he loses the use of this substantial portion of his revenue only temporarily. His business is already severely strained by the inflation raging in this country, and the pricing policies of the oil producing nations. His operating costs are skyrocketing -- estimated to be approximately 71% of his gross revenue. Withholding, even though temporary, will deprive the indepedent operator of desperately needed funds.

If the Treasury Department's proposal is enacted, we submit that a substantial number of these small businessmen will be forced out of business.

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INTRODUCTION

We appreciate the opportunity permitted us to participate in the hearings before the Subcommittee. The American Trucking Associations, Inc. (ATA) is the national organization of the trucking industry, a federation of associations in the 50 states and the District of Columbia, together with 13 national conferences which represent each of the specialized types of motor carrier operations. As such, we represent all types of motor carriers of freight, both for-hire and private.

This statement was formulated and prepared in conjunction with the ATA Committee on Operating Practices (Committee), which is a standing ATA Executive Committee comprised of motor carrier executives from all segments of the motor carrier industry. The Committee was specifically established by the governing body of ATA to consider and deal with issues arising out of the industry's reliance upon independent contractors for the motor transport of freight throughout this nation.

We appear today to urge that this Subcommittee, and the Congress, continue the historic status of the "independent truck operators" as independent businessmen, exercising their entrepreneurial spirit and talents.

Furthermore, we urge this Subcommittee, and the Congress, not to further strain the limited financial resources of these independent small businessmen by imposing a withholding tax upon their receipts, which they so sorely need to meet the great demands imposed upon them by inflation and the fuel crisis, as well as other economic burdens.

The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these "independent operators". This dedication comes from the fact that the "independent truck operator" is an independent businessman, in control of his own work habits, and to that extent in control of his own destiny.

The "independent truck operator" is the classic example of the American dream of owning your own business -- "working for yourself" -- and, therefore, is the prototype small businessman.

As the Subcommittee on Special Small Business Problems of the House of Representatives' Committee on Small Business noted (H.R. Rep. No. 95-1812, 95th Cong. 2nd Session, 1978):

> "Throughout the interstate motor carrier industry is a trucker who has been referred to as 'the last American cowboy'. The American public pictures

> him riding the range perched high in his cab, listening to country and western music. A close-up look at this adventurous trucker reveals an independent-styled small businessman who is working hard to earn a decent living for himself and his family."

Their continued existence as small businessmen, and the vitality of this country's motor transport system, which is so heavily dependent upon their entrepreneurial spirit, demands that the "independent truck operators" status as independent contractors, their historic status, be continued unimpaired.

The monthly cash demands imposed upon an independent operator are substantial. These demands reflect his cost of investment, maintenance of equipment, operating expenses and, of course, the support of his family. To subject the receipts of these independent small businessmen to as yet an additional substantial expense, in the form of a withholding tax, without an adequate showing of need for such withholding by the Internal Revenue Service, will drive thousands of these entrepreneurs over the brink of financial disaster and out of business, to the great detriment of the motor carrier industry and the country.

The trucking industry has found the common law to be instructive in determining an "independent operators" status as an independent contractor. <u>We urge that the common law in this regard not be tampered with</u>.

Nevertheless, we are fully aware of the continued attack by the Internal Revenue Service upon the small businessman's status as an independent contractor. Therefore, we support a legislative effort, exemplified by S. 736, amended as we propose -- the Dole bill -- and H.R. 3245 -- the Gephardt bill -- to establish certain so-called statutory "safe harbor" rules based upon the common law, in addition to the common law of section 3121 of the Internal Revenue Code (Code), to determine an "independent operators" status as an independent contractor.

As we understand Senator Dole's and Congressman Gephardt's proposals, the independent truck operator would be entitled to rely upon the common law tests in determining his status as an independent contractor, or alternatively, make use of the "safe harbor" rules to establish his status. Furthermore, it is our understanding that the common law rules and the "safe harbor" tests are not intended to be mutually exclusive -- an independent truck operator may use either in determining his status under the Federal tax laws.

It might be helpful to the Subcommittee if we briefly outlined the common law rules that have established the independent contractor status of independent truck operators.

INDEPENDENT TRUCK OPERATORS AS INDEPENDENT CONTRACTORS

For purposes of the Federal Insurance Contributions Act (FICA), section 3121(d)(2) of the Code defines the term employee to mean any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee, if the contract of service contemplates that substantially all of such services are to be performed personally by such individual. An exception to this rule is that an individual shall not be included in the term employee if such individual has a substantial investment in facilities used in connection with the performance of such services, other than facilities for transportation. The "other than facilities for transportation" was not intended to, and does not, encompass transportation facilities when they are an essential part of a trade or business.

This definition is in effect incorporated into the Federal Unemployment Tax Act (FUTA) and the Collection of Income Tax At Source On Wages law (Withholding Tax).

Independent truck operators generally own their own power units (the tractor); a relatively small percentage lease this equipment from a carrier or a third party. In either case, the independent operators control their own day-to-day operations, subject to the regulatory requirements

of the Interstate Commerce Commission (ICC), the Department of Transportation (DOT), and other Federal as well as state agencies. They are not supervised in their daily routine by the motor carriers. Many independent operators haul freight over long distances across the country. Some may go for many days or weeks with the only contact with the motor carrier being a telephone call to find freight to haul or to advise of delivery.

Some independent operators own one unit of equipment; others may own a fleet, sometimes including as many as twenty or more units.

In general, independent operators are compensated by an agreed division with the motor carrier of the revenue paid by the shipper for the haul, or by a formula which takes into account the weight of the freight and/or the miles driven. Most of the revenue paid to the carrier -- usually from about 60 to 75 percent or more depending upon the commodities hauled or the equipment furnished by the independent truck operator -- is paid over to the independent truck operator pursuant to an agreement for the division of the revenue.

Independent operators bear their own operating expenses. We will discuss these in greater detail in the part of this statement dealing with the Treasury Department proposal

with respect to a withholding tax. It is important here to note, however, that these operating expenses are substantial.

Independent truck operators provide all necessary labor. Many independent operators who own one rig operate the equipment themselves, while some hire drivers. Independent operators who own a fleet of trucks may employ a substantial work force including drivers, drivers' assistants, mechanics, and office personnel.

In addition to labor expenses, major expenses borne by the independent truck operators in general include fuel and maintenance costs, finance costs, depreciation, collision insurance, highway tolls, state permit and license fees, and various Federal and state taxes.

The independent contractor status of independent truck operators for employment tax purposes was first challenged by the Internal Revenue Service in a series of cases in the 1940's. That controversy culminated in a Supreme Court decision, Harrison v. Greyvan Lines, Inc., 331 U.S. 704 (1947), which recognized the independent operators status as independent contractors. The Supreme Court's decision that these contractors are independent -- but not the Court's adoption of an "economic reality" test -- was expressly confirmed by Congress,

which reaffirmed the "common law" test, in the 1948 and 1949 amendments to the Social Security Act. (S. Rep. No. 1255, 80th Cong., 2d Sess. 2, 4, 13, 16, 1948; H.R. Rep. No. 1300, 81st Cong., 1st Sess., 189-91, 202-04, 1949).

The Internal Revenue Service acquiesced in the treatment of independent truck operators as independent contractors until the early 1970's, when it again began to challenge the relationship in a number of cases. The actions taken by the Service in 1972 and 1973 with respect to the trucking industry could serve as a model for similarly-affected industry groups.

In 1969 and 1970, the Service had reissued three Revenue Rulings which were based upon Social Security Tax rulings which had been issued in the 1930's. These rulings are Rev. Rul. 69-349, 1969-1 C.B. 261; Rev. Rul. 70-441, 1970-2 C.B. 210; Rev. Rul. 70-602, 1970-2 C.B. 225. Although these rulings did not address the current pattern of operations, Revenue Agents began to rely upon them in asserting that an employment relationship existed in a number of cases. Huge retroactive assessments were proposed against the motor carriers involved.

It was at this point that the National Office of the Internal Revenue Service adopted a procedural method designed to resolve the cases fairly and equitably, and without the need for extended litigation.

As a first step, the National Office solicited the submission of approximately a dozen cases for Technical Advice. The cases were selected to represent a broad cross section of the trucking industry. The Service studied the operations of the carriers and the independent operators engaged by them. Working in cooperation with trucking industry groups, the Service issued a set of Guidelines [Internal Revenue Manual 46(10)(2)] by which to determine the status of independent truck operators. The Guidelines identified six factors commonly found in the relationship between independent truck operators and carriers, and stated that there would be a "strong inference" of independent contractor status when these factors were present. The then-pending cases were resolved by reference to these Guidelines. Contracts between the carriers and independent operators were, in many instances, revised to make it clear that an independent contractor relationship existed in line with the Guidelines.

The Guidelines are written so that they can be easily understood and applied by examining agents as well as by motor carriers and independent operators. The overwhelming majority of employment tax cases involving the trucking industry have been resolved by reference to the Guidelines. The Guidelines

have generally eliminated the turmoil caused by enormous proposed assessments and have enabled the independent operators and carriers within the trucking industry to go about their business with reasonable certainty that their independent contractor relationship will be respected for withholding and employment tax purposes.

The six factors identified by the Guidelines as creating a strong inference of the independent contractor status of the independent truck operators are:

1) The independent operator owns the equipment or holds it under a bona fide lease arrangement.

2) The independent operator is responsible for the maintenance of the equipment.

3) The independent operator bears the principal burdens of the operating costs, including fuel, repairs, supplies, insurance and personal expenses while on the road.

4) The independent operator is responsible for supplying the necessary personal services to operate the equipment.

5) The independent operator's compensation is based upon a division of the gross revenue or a fee based upon the distance of the haul,

the weight of the goods, the number of deliveries, or a combination of these factors.

6) The independent operator generally determines the details and means of performing the services, in conformance with regulating requirements, operating procedures of the carrier and specifications of the shipper.

The Internal Revenue Service concluded in Internal Revenue Manual 46(10)(2)(4) that:

> "The [six] factors [set forth above] give contract operators substantial opportunity for profit and loss and the risks of enterprise, which are indications of independent contractor relationships. Economic factors alone, however, are not conclusive when the company meaningfully controls the details and means used by the contract operators. Such controls do not include those which a carrier imposes upon its drivers in order to direct them as to the results to be achieved. For instance, a company rule that drivers report regularly or frequently in a prescribed manner to receive work assignments should not be considered significant. In addition, operating requirements imposed by governmental regulations require that a carrier's name appear on the operator's equipment and, therefore, such identification is not evidence of company control."

THE PRESENT AND
THE FUTURE

If, and so long as, the Internal Revenue Service (Service) applies the Guidelines fairly and consistently there would be no need for legislation insofar as the trucking industry is concerned.

However, we believe that there has been some movement by the Service away from the stability provided the industry by the Guidelines. We understand that the National Office of the Service has proposed in a Technical Advice memorandum involving a trucking case to find an employer-employee relationship, even though in substantially identical cases reviewed at the time when the Guidelines were issued the Service found that an independent contractor relationship existed.

Furthermore, there has been some informal indication that the National Office of the Service is considering the issuance of a revenue ruling that would be a companion to Rev. Rul. 76-226, 1976-1 C.B. 322, but which would set forth certain facts and circumstances and conclude that the relationship involved was that of employer-employee rather than independent contractor. Rev. Rul. 76-226 applied the Guidelines and concluded that an independent contractor relationship existed, rather than an employer-employee relationship.

Shifting determinations by the Internal Revenue Service in other industries are the source of the current problem. The "bracket ruling" concept -- one finding an independent contractor relationship and another finding an employer-employee relationship -- has created a vast area of uncertainty in other industries, and has resulted in the creation of a substantial number of controversies rather than putting cases to rest. While a "companion" ruling involving the trucking industry would not necessarily have the same effect, there is a potential for substantial confusion.

Consequently, the legislative enactment of "safe harbor" rules -- rules that take account of the operating practices of the trucking industry -- would receive the strong support of the trucking industry.

LEGISLATIVE PROPOSALS

There are currently pending before Congress several legislative proposals which are directed toward clarifying the withholding and employment tax status of independent contractors and those who engage their services.

These proposals are in addition to any consideration of any extension of section 530 of the Revenue Act of 1978 (with or without a cutoff date) or to consideration of section 530 without an expiration date as a permanent substantive remedy to this problem.

Two of the bills, S. 736, introduced by Senator Dole, and H.R. 3245, introduced by Congressman Gephardt, are essentially the same, with the only substantive difference being the existence of a "no inference" provision in the House bill. Each seeks to amend the Internal Revenue Code of 1954 in order to clarify the standards used for determining whether individuals are or are not employees for employment tax purposes. The are general in nature and neither is directed to any specific industry.

Another bill, S. 987, sponsored by Senators Leahy and Stafford, does, however, address itself to one particular industry. Pursuant to its provisions, this legislation would exempt from employment tax treatment those individuals who are engaged in the harvesting of timber. The net effect of this bill would be to insure the independent contractor status of those particular persons.

And, of course, the Treasury Department proposed in its testimony before the Subcommittee On Select Revenue Measures of the House Ways and Means Committee, on June 20, 1979 a flat rate withholding tax to be applied against "***payments made in the course of a trade or business for services provided by an independent contractor", in addition to certain measures to strengthen the information reporting requirements of present law. The testimony of the Administration's witness before the Ways and Means Subcommittee made clear that its proposal was not intended to resolve the definitional questions arising out of the relationship existing between the provider of the service and the payor, but rather was intended to ease the administrative burden upon them in collecting revenue, and to prevent what they allege to be large scale noncompliance with the tax laws.

We will discuss each of these proposals and a General Accounting Office (GAO) proposal in some detail.

S. 736 and H.R. 3245

As we noted, with the exception of the inclusion of the "no inference" provision in the Gephardt bill, there is no distinction between it and the Dole bill. Since, however, it is an important distinction, the inclusion of a "no inference" provision in any legislation is strongly supported and urged by the motor carrier industry.

Our specific comments will be directed to the Gephardt bill, since it already contains the "no inference" provisions.

As proposed, the Gephardt bill would create a two-tiered test, only one of which need be satisfied, to be used in the determination of independent contractor versus employee status.

The first tier consists of what have been referred to as "safe harbor" tests; five tests, which if met will qualify the provider of the services for treatment as an independent contractor for employment tax purposes. The bill provides, however, that failure to satisfy the five criteria will not automatically render the status of the provider of the services to be that of an employee.

Rather, the "no inference" clause operates as a bridge between the safe harbor provisions and the current provisions of the Internal Revenue Code which incorporate the common law rules. In other words, the fact that the safe harbor provisions are not met creates "no inference" of employee status. In such a case, reference is made to the common law for determination of the status of the provider of the services.

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While we support, in general, the Gephardt bill, it is not without problems. In explaining the purpose of his bill, Congressman Gephardt had this to say:

> "Mr. Speaker, the purpose of the bill is to establish rules that for employment tax purposes can be easily applied in those industries where the IRS' reclassification program has disrupted business relationships and threatened the very existence of the independent business. An overriding purpose of the bill, therefore, is to preserve the status of workers who have historically been treated as independent contractors." (Emphasis supplied)

The independent truck operator of the motor carrier industry has historically been treated as an independent contractor. As noted earlier, the industry has received a favorable decision from the United States Supreme Court in Harrison v. Greyvan Lines, Inc., 331 U.S. 704 (1947). A favorable decision was also rendered by the Court of Appeals in United States v. Mutual Trucking Co., 141 F.2d 655 (6th Cir. 1944), and by the IRS in its "Guidelines" and in Rev. Rul. 76-226, 1976-1 C.B. 322.

Moreover, for purposes of clairty and as a practical assistance to the tax administrators and taxpayers, the Committee Report should include examples of independent truck operators meeting the safe harbor provisions.

We are prepared to work with this Subcommittee and its staff in making suggestions and drafting language for a Subcommittee report explaining the application of the safe harbor rules to assure that the independent operators and the trucking industry are acknowledged as coming within their terms.

S. 987

An alternative to the proposals of S. 736 and H.R. 3245 is the specific exemption format of S. 987, the Leahy-Stafford bill. While we certainly would not object to the passage of this bill, and would, obviously, support a similar bill directed toward the independent operators and the trucking industry, we nonetheless recognize the inherent problems faced by this form of legislation. The myriad of bills that would need be considered, let alone passed, in order to address all of the industries affected by the independent contractor issue, militates against urging that type of legislation as an answer to the problem. Accordingly, we proceed along the line that S. 736, if amended to include the "no inference" provision or H.R. 3245 best addresses the overall issue.

GAO PROPOSAL

The GAO has recommended a "safe harbor" rule consisting of four basic tests which, while similar to S. 736 and H.R. 3245, present some distinctions which must be noted. Unlike the tests contained in S. 736 and H.R. 3245, the GAO proposal would require that a separate place of business be maintained and that it be a place of business which satisfies the provisions of section 280A of the Internal Revenue Code. Whether or not a separate place of business qualifies for business deductions under 280A, however, should not be a crucial factor; to conclude otherwise confuses the real issue. The question here is what is the relationship of the provider of the services to the payor? Insofar as a principal place of business is concerned, qualification under 280A is purely tangential; that the payor not provide the facilities free of charge to the provider of the services is all that should really matter.

In addition, the GAO proposal would require that to meet the safe harbor tests the provider of the service must hold himself out in his own name as self-employed and/or make his services generally available to the public. This test raises certain problems.

For one, this GAO proposal fails to specifically address and define what constitutes a "holding out." Also, we direct the Subcommittee's attention to the fact that specific Federal regulations relating to the trucking industry require

displaying the carrier's placard on the independent operator's tractor, which might appear to preclude our industry from complying with this particular requirement. It seems most probable that there are other industries which too would be prevented from meeting this test because of contravening government regulations.

Whether, therefore, it is this particular GAO test, one propounded in the Dole or Gephardt bills, or any other test which may be proposed, the inability of a provider of services to comply with a particular test because of rules imposed upon him by other Federal or State laws or regulations should not prohibit him from having the benefit of the safe harbor rules.

A further distinction between the GAO proposal and S. 736 and H.R. 3245 lies in the requirements for compliance with the enumerated safe harbor tests. Under S. 736 and H.R. 3245, satisfaction of all five tests is mandated. Failure to meet all of the tests results in reference to the common law test, without any inference created as to employer-employee status. The GAO proposal, on the other hand, provides for the application of the common law tests in the event that only three of the four safe harbor tests are met. When less than three of the tests are met, the provider of the services will be deemed to be an employee.

While the difference here may appear to be more form than substance, a failure to modify the GAO position to take account of the operating rules applicable to the trucking industry, insofar as the principal place of business test is concerned, as well as to specifically recognize conflicting Federal and State laws and regulations may result in a determination contrary to the long standing determination of the independent contractor status of the independent truck operator.

TREASURY PROPOSALS

In oral and written testimony presented to the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on June 20, 1979, the Treasury Department portrayed a picture of "widespread non-compliance" in the reporting of income, and the payment of income and social security taxes with respect to revenue received by independent contractors. The statement of Assistant Secretary of the Treasury Lubick alleges that "*** at least 47 percent of workers treated as independent contractors did not report any compensation in question for income tax purposes. An even greater percentage, 62 percent, paid none of the social security tax due on their compensation."

Zero compliance in the trucking industry, according to the Treasury study, is alleged to be 54.2 percent with respect to income tax, and 64.9 percent with respect to SECA taxes.

Mr. Lubick also testified (page 7 of written statement) that "the IRS estimates that fewer than 60 percent of the required information returns for nonemployee compensation are actually filed."

To resolve these purported problems, the Administration proposed that:

-- A flat rate of ten percent be withheld from payments made in the course of a payor's trade or business for services provided by certain independent contractors.

-- Exceptions from the withholding tax be permitted where the individual provides similar services to five or more payees during each calendar year, or where the individual expects to owe less tax than the amount to be withheld (taking into account any taxes being withheld by other payors). In either event, the worker electing out of the system need only check a box and sign a form that would provide the payor with the worker's name, address, and social security number.

-- More substantial penalties be authorized for failure to file information returns; there be a reduction in the penalty tax assessed against payors whose workers have been reclassified as employees; and, there be a requirement that payors furnish copies of information returns to workers and a penalty for the failure to do so.

-- In the future, consideration be given to correcting the disparity between Federal Insurance Contributions Act and Self-Employment Contribution Act tax rates.

In the alternative, the Treasury proposed the replacement of the common law test and the imposition of a "*** graduated rate withholding on all workers paid other than on a wage or salary basis, unless the gross payments received by a worker would not approximate his or her net income and it is likely the worker would provide services to multiple payors." The Administration proposes, for example, that graduated rate withholding be required on compensation paid to independent contractors unless a worker had (1) a separate place of business, (2) a substantial investment in assets, (3) employees of his own or (4) substantial, continuing expenses and concurrently performed services for more than one payor.

The Treasury's proposal is constructed to resolve a perceived problem -- substantial noncompliance. The existence of the perceived problem is based upon the Internal Revenue Service compliance study undertaken in the latter part of 1978 and early 1979.

We have substantial reservations about the validity of that study, not only its results but its methodology as well. Of significant concern to us is the fact that while the results purport to apply to all independent contractors, the sample from which the study was drawn consisted of those persons whom the Service had proposed to reclassify from independent contractors to employees.

The Subcommittee is, I am sure, aware of the fact that the Internal Revenue Service refused to disclose much of the background information dealing with the study and its conclusions in a letter from the Service dated May 16, 1979 which responded to a request for such data under the Freedom of Information Act, 5 U.S.C. Section 552. On July 5, 1979, the Service, without public fanfare, made available some 5,000 to 6,000 computer printout sheets containing background data with respect to its compliance study. The material comprises eight bound volumes, which while labelled with respect to their content, are neither indexed nor do they contain the standards of the study or definition of terms.

While the number of individuals comprising each industry group is provided in the base data, it is not clear whether or not the individuals are properly classified in their industry category, or within subgroups within a particular industry. It should also be noted that those cases

which did not contain enough information to provide what the Service considered a "reasonable possibility of follow-through" were dropped from the study.

While the implication is left with the reader that the persons who could not be located deliberately failed to submit returns and pay their taxes, we submit that such inference is grossly unfair based upon the information provided in the study. For many years, the Service has consistently refused to adopt a change of address form that taxpayers could submit to inform the Service of their change of location. The Service consistently uses the address on the tax return they are reviewing, which in most cases is two to three years old. In our mobile society, it is not at all unlikely, as the GAO pointed out in its July 11, 1979 report on "Who's Not Filing Income Tax Returns?", GGD-79-69, that taxpayers have moved from one location to another within that time frame -- and moved for economic or family reasons -- not for the sinister purposes implied by the Service's compliance study. We also know that the United States Postal authorities maintain the change of address forwarding service for only one year.

The ATA purchased a copy of all of the material released by the Service, and undertook to have its staff analyze the material. The research staff has raised substantial questions with regard to validity of the conclusions of the study, and specifically with respect to the conclusions as they relate to the trucking industry.

We have also retained an unrelated consultant to analyze the Internal Revenue Service Study. The consultant's preliminary report seriously questions the validity of the study, and states that the conclusions of the study are not supportable by the sample and methodology used by the Service. We will be pleased to share the final report with the Congress.

We do note that the Service's background data shows that 700 taxpayers comprised the "trucking" category of the study. But, only 396 of those taxpayers were "drivers" -- independent truck operators. Yet the Service's study indiscriminately implies that the alleged noncompliance percentages presents a valid portrayal of the independent truck operator. We submit that this is simply not so.

It is also interesting to note that the background data, at one point, indicates that there was insufficient information with respect to 148 of the 700 taxpayers involved -- 21.1 percent of the trucking category. Yet, later data seems to indicate that 64 of those taxpayers were subsequently found to have previously filed returns, and 7 were found not to be required to file.

We note these matters simply to show that important questions about the Service's compliance study do exist. We understand that the GAO is also looking at some of these questions. We will be interested to read their report when it is available.

In the time available to us since June 20th, we also undertook to question some of our members with respect to their reporting compliance. We sought this information from seventeen of our members from various gross income groups, who were geographically dispersed. We do not claim that our survey was scientifically structured; nevertheless, we feel the results are illuminating.

Sixteen members responded, all of whom said that they filed From 1099 with respect to payments to independent operators who had hauled freight for them. It is also important to note that all of the respondents voluntarily provided copies of the 1099 Forms to their payees, a requirement that the Treasury Department is now seeking. In our opinion, this is a more accurate reflection of what our industry is doing than is the Service study.

The results of the study and the Treasury's proposals are tied directly to the soundness of the methodology of the compliance study. It is essential, therefore, that those affected by the proposals have access to the full methodology and the detailed background data in a comprehensible and usable form.

We also note that in Table 1 attached to the Treasury's written statement it is reported that where the independent contractor's amount of compensation (as corrected) is $50,000 and over the percentage of compensation reported for income tax compliance purposes is 98.4 percent, while the percentage of Self Employment Contribution Act tax paid is 66 percent. This Table also notes that for this compensation level the percentage of payees with full income tax compliance is 92 percent, while compliance with some or all of the SECA tax is 66.7 percent.

We cite these figures since our survey, albeit unscientific, clearly shows a profile of the independent operator as receiving compensation in excess of $50,000 per annum. In addition, one carrier, who contracts with approximately 800 independent operators during the course of a year, constructed a profile of the average operator. This demonstrated that the average annual amount of compensation received by the independent operator is $55,000.

The results of these surveys give further support to our serious concern about the validity of the statements by the Treasury Department with respect to the alleged noncompliance by the independent operators of the trucking industry.

Even more important than our doubts about the validity of the Service's study is our acute awareness of the financial impact of a flat 10 percent withholding tax on the industry's payments to independent operators.

In its Report on The Regulatory Problems of the Independent Owner-Operator In The Nation's Trucking Industry (H.R. Rep. No. 85-1812, 95th Cong., 2d Sess., 1978) the Subcommittee On Special Small Business Problems of the Committee On Small Business concluded that the independent operator is a "vital segment of the motor carrier industry."

If this vital segment of our industry is unable to meet the rapidly escalating fuel and other costs it faces, it will cease to exist, to the great detriment of the country. It is critical to note that what is at issue is not what the independent operator's margin of profit should be, but rather, and more importantly, whether the independent operators will be able to meet their increasing costs in order to survive in business.

The plight of the independent operator in meeting his costs was recognized by the Subcommittee on Special Small Business Problems which described it as a "continuing cost crunch ... [resulting from such factors as] ... the cost of equipment [which] alone has almost doubled in the past few years, and the cost of fuel [which] has in many cases more than tripled."

We believe that it is significant that the Subcommittee recognized the fuel problem in advance of the crisis with which the independent operators are presently confronted.

We estimate that on average, approximately 71 percent of an independent operator's gross receipts are consumed by fixed and operating expenses -- fuel, maintenance, finance costs, depreciation, insurance, tolls, permit and license fees and operating taxes. The profile developed by the carrier referred to earlier showed that the independent operator's average operating expenses totaled $39,000, resulting in his having remaining disposable income of $16,000. To these operating expenses the Treasury Department is proposing to add as an expense an additional 10 percent of the independent operator's gross revenues. To take a further 10 percent from an amount of compensation that is already squeezed in meeting fixed costs and operating costs that are rapidly escalating as a result of inflation is unconscionable.

Clearly, the independent operator will not owe in taxes anywhere near the equivalent of 10 percent of his gross revenue. With an adjusted gross income of $16,000, we would estimate that exemptions and deductions would reduce the average independent operator's taxable income to approximately $10,000, which would result in a maximum income and self-employment tax of $1,875.

Given the fact of escalating fuel and other costs that make it increasingly difficult, if not impossible, for independent operators to continue operating, the additional burden of tax would further reduce his disposable income and imperil the continued and viable existence of this vital segment of our industry.

If the answer is that the independent operator could opt out of the withholding tax by simply filing a form with the Service, what purpose has this elaborate Treasury program served? We submit that the Treasury is building a straw man to be shot down by a withholding tax whose real purpose is to ease the collection of tax function of the Service.

We strongly object to such a proposal where the consequence will be the likely financial ruin of the independent operator.

The Treasury Department states in its testimony (at page 4 of the written statement) that an estimate of the annual revenue loss from the noncompliance by independent contractors is $1 billion dollars. The revenue gain estimate from the purported increased compliance that is to result from the Treasury's proposals is $600 million -- but at the cost, we submit, of driving a substantial number of the trucking industry's independent operators out of business.

We read reports by and hear statements from Internal Revenue Service officials indicating that some $4 billion dollars of revenue is lost to the Treasury Department because taxpayers fail to report dividend and interest income for tax purposes. This revenue loss exists even after a substantial strengthening of the information reporting requirements applicable to payors of dividends and interest.

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We suggest that the Treasury Department consider directing its energies to expanding the witholding tax in that area, an area which it claims has four times more revenue potential than it claims existsin the independent contractor area. Not only can the Treasury Department substantially increase its revenue collection estimates by seeking withholding from dividend and interest payments, it can accomplish this without driving thousands of independent trucking operators out of business.

We submit that such a program would apparently be far more worthwhile. The Treasury should undertake such a program, rather than further burdening the already strained and limited financial resources of the independent truck operators.

While we strongly oppose the imposition of a withholding tax upon the revenues of the independent truck operators, we do not countenance taxpayers evading their fair share of the tax burden imposed upon our citizenry. All must shoulder the financial burden of supporting our Government.

Consequently, we would support the Treasury Department's request for

-- an increase in the penalty for failure to file information returns;

-- a requirement that payors be required to give payees a copy of the information return;

-- that information reporting be extended to compensation paid to salespersons based upon the difference between the cost and selling price of goods sold; and

-- a more realistic penalty to be imposed upon the payor who unreasonably fails to withhold.

The need for a more realistic penalty to be imposed upon a payor who unreasonably fails to withhold tax further confirms one of the principal shortcomings of the Treasury Department's proposal -- the lack of well defined rules for determining who is an independent contractor. Assistant Secretary Lubick, in response to questions from Subcommittee members, acknowledged that that issue would not be resolved under the Treasury's proposals. He testified that, at best, the magnitude of the issue would only decrease.

It seems clear that the independent truck operators of our industry might continue to face the uncertainty of their status and the attacks of the Internal Revenue Service even if the Congress were to enact all of the Treasury's present

proposals. We submit that if that course of action is adopted by the Congress then Congress will be faced with this very issue again in the very near term.

The Treasury Department's proposal, therefore, fails to accomplish any major goal since it ignores the definitional aspect of the independent contractor issue. Safe harbor rules are, we submit, essential.

The Treasury also urged that the Congress consider correcting the disparity between the FICA and the SECA tax rates as a part of the broader issue of social security financing. We would not disagree with the suggestion for considering that matter. Nevertheless, the Treasury's allegation that "*** independent contractors bear less than their fair share of the social security tax burden even when they report all of their income[.]" is, we submit, falacious, and indicative of the generally biased approach of the Treasury Department and the Internal Revenue Service against the independent small businessman.

The Treasury bases its questionable conclusion upon the statement that:

> "*** Although employees and independent contractors receive identical social security benefits, the social security

taxes imposed on independent contractors under the Self-Employment Contributions Act (SECA) are lower than the social security taxes an employee must bear under the Federal Insurance Contribution Act (FICA). (Although one-half of the FICA tax is technically paid by the employer and one-half by the employee, in an economic sense the entire burden of this tax is borne by the employee.)"

The Treasury Department has consistently failed to produce any empirical evidence to support the parenthetical sentence cited from their testimony.

Moreover, while it is true that the SECA tax imposed on the independent contractors is approximately seventy-five percent of the combined employer and employee FICA tax, the employer is entitled to claim a deduction under the general income tax rules for the employer's share of FICA. The employer, of course, receives a tax deduction for the entire amount of compensation paid to the employee. We understand that the net effect of this tax treatment is that the total burden differential is substantially less than one percent.

We submit that the Treasury Department's allegation in this respect is unwarranted, and is made solely for the purpose of creating a bias in favor of their proposals.

TRUCKING INDUSTRY
RECOMMENDATIONS

We seek to assure that the historical independent contractor status of the motor carrier industry's independent truck operator is preserved.

We strongly oppose the Treasury Department's proposal for a withholding tax on all payments made in the course of a trade or business to an independent contractor for the reasons already noted. The Treasury's proposals do not resolve the definition issue, and do not remedy the alleged compliance problem.

Yet, it will surely, we submit, result in the financial ruin of a substantial number of small businessmen.

-- Are not the independent operators sufficiently burdened by the inflation raging in our country today?

-- Are not the independent operators sufficiently burdened by the devastating and outrageous pricing policies of the oil producing nations?

-- Must their own Government impose upon them the final blow by unreasonably invading their already severely strained financial resources?

We urge this Subcommittee, and the Congress, not to be a party to this final devastating act.

The status of independent contractor or employee has been and should continue to be one of choice. It should be based upon the contractual agreement of the parties.

What is at issue is the continued existence of the independent truck operator as a vital, viable and productive part of the motor carrier industry. Should the Treasury be allowed to eliminate this small businessman from the American scene?

If an independent operator is unable to meet the test necessary to have the status of an independent contractor, it should be by choice. If an independent operator is unable to satisfy the test to qualify as an independent contractor, where historically he has been able to satisfy the test, it should be the exception rather than the rule. If an independent operator is unable to satisfactorily demonstrate compliance with the independent contractor test, it should not be because the test fails to take account of governmentally imposed burdens with which the regulated parties have no choice but to comply; where conflicting burdens do exist the test should recognize this. The enactment of legislation which fails to consciously address these general problems, applicable to any industry, will fail in its stated purposes of preserving the historical status of independent businessmen, and eliminating confusion, hardship and inequitable treatment.

Again, let us note that we are opposed to the enactment of any legislation which would impose upon the independent truck operator the burden of a withholding tax.

We recommend the enactment of the Dole bill, with the "no inference" amendment, the Gephardt bill or similar legislation. However, in recommending this course of action, we restate our position that Congress must enact safe harbor criteria whose application is not such that "bona fide subcontractors might not be able to satisfy the strict requirements of the bill."

To accomplish what we recommend with respect to the Dole and Gephardt bills, however, does not require the redrafting of the safe harbor tests set forth in those bills. Recognition of circumstances beyond the control of the parties, contravening laws or regulations for example, can be dealt with as part of the legislative history. As a result, safe harbor provisions which could be met but for uncontrollable circumstances will be met, the possibility of inequitable or inconsistent application of the law will be reduced, and the independent contractor small businessman status will be maintained.

We further urge that the common law rule be retained, even with the enactment of the safe harbor provisions. This we understand to be the goal of S. 736 and H.R. 3245.

Thank you.

Duncan McRae, Jr.

INTERNATIONAL FRANCHISE ASSOCIATION

Summary: IFA Statement on S.736 before the United States Senate Finance Committee, Subcommittee on Taxation and Debt Management Generally

Delivered by James D. McCarthy, Vice President, Tax and Business Services Group of General Business Services, Inc., representing the International Franchise Association

September 17, 1979

The International Franchise Association (IFA), consisting of over 360 member companies who use franchising in their business operations, supports S.736 sponsored by Senator Dole. IFA represents the franchising method of doing business; our members range over 40 diverse industries, from the more familiar national fast food operations to hotels, tax services, pet shops, to weight control centers, and business service companies such as my own.

A major characteristic of franchising is the independent business ownership and operation of a business by the franchisee. In every sense of the word, the franchisee is an independent contractor. He owns and operates his own business with an opportunity for profit or a risk of loss with the guidance of his more experienced franchisor.

Typically, the franchise relationship involves the licensing of a tradename and contracting for a fee to allow the franchisee to operate the business under that tradename. Payments for the license flow from the franchisee to the franchisor, either in the form of an initial payment or more usually a combination of initial payment and an ongoing royalty. The royalty is generally a percentage of gross sales which is forwarded to the franchisor at regular intervals. The franchisor, also bound by the franchise agreement, provides a variety of services, training and expertise to the franchisees in his system, promoting their individual growth and the strength of the franchise system as a whole.

It is vital to the continuedgrowth and existence of franchising, one of the fastest growing areas of the national economy, that the independent status of the franchisee is preserved. Franchising now accounts for fully one out of three retail dollars spent in the United States and employs more than 4 million workers. Much of this growth has been attributed to the basic nature of the franchise relationship: it provides the small businessman with an opportunity to get into business and the assistance of a franchisor who offers both expertise and a proven, market-tested business format. The IFA believes that the Dole Bill, S.736, and its companion bill in the House, H.R.3245, will protect the vital independent status of the franchisee. Franchisees, generally incorporated, occasionally publicly traded companies, would easily fall within the safe-harbor test contained in the Dole Bill. Clearly, franchisee businesspeople operating their own

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establishments for their own profit and loss should under no circumstances be construed as employees of their franchisors. For this reason, we suggest that the 'control of hours' test be applied to the hours worked by an individual, not the hours of his business which is often determined by the franchise agreement.

Treasury Proposal Would Ruin Franchising

Franchising could be destroyed if the Congress were to adopt the Treasury Department's recommendation to the House Ways and Means Committee that an across the board 10 percent witholding be applied to all independent contractors. The IFA objects to this proposal for several reasons:

**The Compliance Study, upon which the Treasury proposal is based is unscientific and misleading as applied to franchising and is statistically unsubstantiated. The sample drawn is inherently biased and not large enough to be statistically reliable.

**"Franchised Operations" as a category of study is nowhere defined and gives no indication whether it refers to the franchised, contractual relationship between the franchisor and the franchisee.

**Many franchises operate on a slim profit margin which would be totally undermined by a 10 percent witholding of gross or net earnings.

**If withholding is applied to a franchise, which party is the payor from whom funds are withheld? Franchise fees flow in the opposite direction from the usual independent contractor relationship. No one has claimed or demonstrated franchisors have engaged in a pattern of noncompliance with the Revenue Code.

The IFA urges passage of the Dole Bill, S.736 without amendment.

Statement by

Mr. James D. McCarthy, Vice President, Tax and Business Services Group
of General Business Services, Inc.
51 Monroe Street, Rockville, Maryland

Member of the International Franchise Association

Mr. Chairman, and Members of the Subcommittee, my name is James D. McCarthy. I am Vice-president, Tax and Business Services group of General Business Services, Inc., of Rockville, Maryland, and I am also chairman of the Tax Subcommittee of The International Franchise Association (IFA) located in Washington, D.C. I am appearing on behalf of the IFA and we appreciate the opportunity to testify in support of Senator Dole's S. 736.

The International Franchise Association is an association consisting of more than 380 firms, large and small, which engage in whole or in part in the franchise method of distribution. The Association provides information concerning franchising and sponsors seminars and conferences dealing with legal and management matters. The IFA is widely recognized as a spokesman for franchisors in all legal and legislative matters affecting franchising. Membership in the IFA is limited to companies that subscribe to and pledge adherence to a comprehensive Code of Ethics. All applicants for membership are screened for business integrity, and to qualify for regular membership a company must demonstrate a sound financial condition and proven business accomplishment.

Independent Contractor Status in Franchising

One of the cornerstones of franchising is the independence of a franchisee who can own and operate this own business while drawing upon the training, experience and market expertise of the franchisor. It has been shown that franchisees have a very good chance of survival and prosperity in highly competitive markets, offering opportunities to many individuals who have only a limited amount of capital and relevant business experience.

Modern franchising enjoys several definitions among the state and federal bodies which regulate it, but none truly reflects the practical nature of the business arrangement. In its simplest practical terms, a franchise is a license from the owner of a trademark or a trade name, the franchisor, permitting the franchisee to market a product or service under the franchisor's name or mark pursuant to procedures established by the franchisor and agreed to in the franchise contract.

The trademark and the trade name have been called "the cornerstone of the franchise system." The license granted to a franchisee for the use of the mark cannot be unrestricted; the owner of the mark or name has a legal duty to the public, and an obligation to all franchisees in the system to assure the quality of the product or service sold under the mark or name. The Federal Trademark Act of 1946, 15 USCA 1051 et seq. (1946) requires that licensor establish and police standards for products sold under a franchise trademark.

The typical modern franchise can be accurately characterized as a contractual arrangement between two independent businesses

in which the franchisee is licensed to use and enjoy the trademark, tradename or business system of the franchisor. In many cases, the franchisee is incorporated and is the owner of several franchised units. And it must be remembered that when we refer to a "typical" franchise arrangement, we are covering vast differences spanning 40 different industries. Usually the franchise involves the payment of an initial franchise fee coupled with ongoing royalty payments, which are stated as a percentage of the gross sales of the franchisee business. In return for these fees, the franchisor provides a variety of services which may include market assistance, training, advertising, accounting services, quality control advice....the list goes on.

When applied to this type of business relationship, the analysis of independent contractor status often leads to anomolous conclusions. Generally speaking, only the royalty fees, certain required advertising contributions and other specified fees are ever remitted to franchisors. The franchisee is responsible for generating revenues through the operation of his business, suffering a loss or making a profit, and paying his own creditors. The franchisee is generally free to transfer his business to another individual or corporation who qualifies under the franchisor's standards for ownership. The "payment" between the payor and the payee is, therefore, flowing in the direction of the franchisor and not vice versa. Who, under these circumstances, is the independent contractor and who is receiving the services? This analysis also becomes strained when applying the Treasury Department's proposal for a 10 percent across the board withholding.

Should the franchisee withhold 10% of his gross revenues? When extended the reasoning goes from anomaly to absurdity.

Only on the rare occasion has the Internal Revenue Service challenged the independent status of a franchisee, but such challenges have occurred. The common law test of twenty factors to be considered in determining independence has in every franchise to our knowledge resulted in the determination that a franchisee is indeed independent. However, these factors have been strained on occasion to support an IRS argument that because of the controls exercised by a franchisor over the independent members of his franchise system, a franchisee would be taxed as an employee of the franchisor.

S. 736

It is for this reason that The International Franchise Association appears today in support of S. 736, sponsored by Senator Dole. This bill would provide a "safe harbor" for franchisors to make certain that their franchisees shall be treated by the Service as truly independent contractors, independent businesses, responsible for their own taxes and their own reporting of income.

Virtually all franchise relationships easily satisfy the safe harbor test for independent contractor status as it appears in S. 736. There are, however, a few areas which we believe should be clarified as they would apply to franchising.

Control of hours worked. The IFA has but one minor suggestion for this first test of the safe harbor:

> (1) Control of Hours Worked - the individual controls the aggregate number of hours

> the individual actually worked and substantially all of the scheduling of the hours worked. (Underlined portion added.)

Our concern here is caused by franchise agreements which specify the hours of retail operation of the business. If a franchise agreement for a restaurant, muffler shop, hotel or pet shop specifies that it be opened to the public during certain minimum hours, it should not deprive the franchisee of safe harbor protection. This type of contract provision usually leaves a particular individual free to set his or her hours of working in the business, and this should qualify under this test of the safe harbor. Our proposed language assures that the section refers to individual control of individual work, and not the hours of a business operation.

The reference to the number of "hours actually worked" is of some comfort here, but the reference earlier in the section to the individual "control[ing]" the aggregate number of hours does concern us. For instance, if a franchise agreement requires that a business be open to the public for a minimum number of hours, requires that a franchisee lend his "best efforts" to the success of the operation, and requires personal participation in the management of the business, does this take "control" out of the hands of the individual franchisee? We think it should not, and we urge that this point be clarified by adding the suggested language.

The filing requirement.

The fifth and final test of the safe harbor for independent

contractor status reads:

> (5) Filing of Required Returns - The person for whom such services performed files any information returns required in respect of such service under section 6041(a).

Based upon the actual experience of one IFA member, this section could be the most harmful to franchisors. Most franchisors pay their franchisees nothing; the flow of franchise fees runs in the direction of the franchisor. Franchisees typically pay franchisors for the right to engage in a business system and for the use of the franchisor's trademark or trade name. The franchise business operates independently, generating revenues which form the base for calculating fees which are then forwarded to the franchisor.

Under such circumstances franchisors should not rationally be required to provide the IRS information on 1099 forms. To argue that the franchisor should supply these forms would require ignoring basic factual characteristics of the franchise relationship. Such an argument has been made unsuccessfully by the Internal Revenue Service. Faced with an IRS challenge the safe harbcr may be denied to a franchisor on this point, who must then grapple with the twenty common law rules now considered by the Service.

Rather than suggest amendment language pertaining specifically to franchising, we urge this subcommittee to send a clear interpretation of this test to the full committee and the Congress that information forms need be filed only to report direct payments to an independent contractor. This section puts the burden of

filing information on the "person for whom such services (were) performed." Once again, this language has a confused application to franchising because of the "services" usually being performed by a franchisor to aid his franchisee. Our concern here is preventing the Internal Revenue Service from engaging in strained factual analysis to apply confusing statutory provisions.

A response to the statement of Donald C. Lubick, Assistant Secretary of the Treasury Department.

On June 20, 1979, a representative of the Treasury Department, Donald C. Lubick, submitted testimony in the House on the question independent contractor status. In his statement, Mr. Lubick made a few sweeping recommendations to this subcommittee and presented the tabulated results of a recent IRS Employee/Independent Contractor Compliance Study. On behalf of the members of The International Franchise Association we stand fast in our challenge of the implication of this compliance study, the methods used in compiling the figures as well as the conclusions and recommendations of the Treasury Department.

The Treasury Department proposes that a flat rate of 10 percent be withheld from payments made in the course of a trade or business for services provided by an independent contractor. The IFA has very serious misgivings about the application of such a taxing scheme to franchising in particular. We suggest to the Subcommittee that such a scheme would be unworkable and in any application to franchising it would be unfair. As with the information reporting requirements, the lack of any "payments" by a franchisor to a franchisee make the application of the ten

percent withholding proposal very confusing indeed. If this scheme is interpreted to require of a franchisee that he withhold ten percent of his gross revenues on which royalties are based, it would work an obvious disservice and we suggest not improve the compliance rates among franchising in general. We would foresee severe cash flow problems being imposed on franchisees who must set aside a ten percent portion of their gross earnings, and the proposal challenges an essential element of franchising -- the business independence of the franchisee. The proposal is unwise and should be rejected.

Even more disturbing to the franchising community is the IRS compliance study. As presented to this subcommittee a series of tables identifies compliance figures on an industry by industry basis, and includes among its lists of separate industries a category referred to as "Franchise Operations." The figures attribute to franchise operations, for instance, a "zero compliance" rate of 51.7%. Upon closer examination of the study we conclude that these figures are patently misleading. As they apply to franchising they present an inaccurate picture of the compliance by franchisees across the country. There are unjustified biases built into these figures and several questions which remain unanswered as to the methods by which the data were collected and categorized. Let us merely mention several of these:

(1) The sample from which these figures were drawn has an inherent bias. Quoting from Mr. Lubick's

testimony, the sample for this study "was drawn from a list of payments which the IRS had proposed to reclassify from payments to independent contractors to payments to employees." Then from this sample a "stratified random sample" was selected. Any conclusions drawn from this sample will be an extreme statement of compliance in franchising. It is only the rare case where the Internal Revenue Service has attempted to reclassify a franchisee from an independent contractor to an employee. These figures therefore explore only the very rare, narrow cases.

(2) Upon examination of the raw data made available by the IRS, we find a very low number of returns upon which the "franchise operations" figures were compiled. We suggest that 60 returns is an extraordinarily small number upon which to indict a method of distribution which, according to the Department of Commerce, represents fully one third of all retail sales in the United States.

(3) "Franchise operations" is nowhere defined, and it is not clear what the Service had in mind when it established this category. The Service's methodology was to ask first the employer and then the employee what industry each considered himself to be a part of. To this question sixty (60) of the employers answered "franchise operation" while only thirty-five

(35) of the "employees" said franchise operation. Fourteen (14) of the employees checked "other." Further questions are raised by a similar cross check as to what each considers his or her "occupation." There was agreement by twenty-two (22) of those included in the sixty returns that they enjoyed the occupation of "manager, distributor." Allow us to point out that within the accepted definition of "franchise", mere "distributors" are rarely included.* This leads us to believe that the phrase "franchise operation" was misconstrued and as presented is very misleading.

(4) There is no working definition of what constitutes a "franchise operation", as pointed out above. A casual inquiry of those Service employees who were involved in the study suggested that the only guideline given on the description of franchise operation was that it "includes gas stations." While franchising may indeed include gas stations, it also includes a highly specialized contractual relationship regulated by states and the federal government in at least 40 different industries. What exactly does the Service mean by a "franchise operation"?

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*See for instance the definitions of the FTC Rule on Franchising and Business Opportunity Ventures 16 CFR 436, and the California Franchise Investment Law, Cal. Corporations Code §310.000 et seq.

(5) There is also a serious question as to what part of the franchise operation these figures are meant to apply. For instance, if a franchisee is granted a muffler shop which is owned and operated by a corporation and that shop hires an independent contractor/employee, it may very well have fallen in the audit conducted by the Service. Our main concern is the line drawn between independent contractor and employee in a franchisor-franchisee relationship. We are concerned that the figures developed by the Internal Revenue Service are off the point of that peculiar relationship. Do these figures refer to a franchisor or is "franchise operation" much broader than that one relationship?

In conclusion, we urge this subcommittee to tread very carefully in this delicate field. Franchising should not be the subject of IRS challenge on what constitutes an independent contractor, but it has been in a few cases. We do not believe that the Dole Bill will induce more challenges in the future but we fear its practical impact if a few of the points we have made are not clarified. We also challenged the IRS Independent Contractor/Employee Compliance Study on several grounds and urge this subcommittee not to be misled by its conclusions, figures and often mysterious methodology. Finally, we would like to thank you, Mr. Chairman, and Members of the subcommittee for the opportunity to present our views on this subject. We will be happy to answer any of your questions or provide more information on franchising.

Thank you.

STATEMENT ON S. 736

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

by the

AMERICAN PULPWOOD ASSOCIATION

Introduction

I am Kenneth Rolston, Executive Vice President of the American Pulpwood Association (APA). Because APA represents both producers and consumers of pulpwood in the United States, the question of the employment or independent contractor status of those in the logging business is of serious and significant import to us. Our membership includes not only those businessmen and firms that the Internal Revenue Service (IRS) has alleged are new "employers" but also the businessmen and firms (the Treasury Department's "workers") who have unwillingly been reclassified by the IRS as "employees". In every instance, the allegation was without legal or evidentiary support.

We support S. 736. However, we suggest that the bill be amended to include the "No Inference" provision found in Section 3508 (d) of H.R. 3245, a bill presently being considered by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee.

Sept. 17, 1979. American Pulpwood Association, 1619 Massachusetts Ave. N.W., Washington, DC 20036 (202-265-0670).

We believe it is in the best interests of this nation that the legitimate, longstanding, and traditional business relationships that exist in the logging industry be maintained and enhanced. We aver that S. 736 is the best means to accomplish that objective.

The following 44 organizations representing logging contractors and other forestry and forest industry interests in 32 states join with APA in support of S. 736:

Alabama Forestry Association
Alaska Loggers Association
Arkansas Forestry Association
Appalachian Hardwood Manufacturers Association
Associated Oregon Loggers
California Forest Protective Association
Florida Forestry Association
Forest Farmers Association
Georgia Forestry Association
Kentucky Forest Industries Association
Louisiana Forestry Association
Maine Forest Products Council
Maryland Forests Association
Massachusetts Wood Producers Association
Michigan Association of Timbermen
Minnesota Timber Producers Association
Mississippi Forestry Association
Missouri Forest Products Association
Montana Logging Association
New Hampshire Timberland Owners Association
New York State Timber Producers Association
North Carolina Forestry Association
Northeastern Loggers Association
Northeastern Lumber Manufacturers Association, Inc.
Northern Hardwood & Pine Manufacturers Association
Northern Woods Logging Association
Oklahoma Forestry Association
Oregon Log Truckers Association
Pennsylvania Forestry Association
Rhode Island Wood Operators Association

South Carolina Forestry Association
Southeastern Lumber Manufacturers Association
Southern Forest Products Association
Southern Hardwood Lumber Manufacturers Association
Southern Oregon Timber Industries Association
Tennessee Forestry Association
Texas Forestry Association
Vermont Timber Truckers & Producers Association
Virginia Forestry Association
Washington Contract Loggers Association
Washington Log Truckers Conference
West Virginia Forests, Inc.
Wisconsin Forest Industries Council
Wood Producers Association of Connecticut

The Merits of S. 736

S. 736 is a positive and realistic solution to what has become, because of misdirected and unmerited IRS activities, an unnecessarily vexing and troublesome problem. It clarifies for logging businessmen and for the IRS who is or is not an independent contractor. It clarifies tax obligations and provides for predictable and equitable enforcement of all the tax laws. Ultimately, S. 736 will enhance voluntary compliance with tax obligations.

We also support this legislation because it does not supplant the traditional common law test. As a matter of fact, we could not support legislation which would substitute safe harbor tests for common law definitions.

Because of the IRS' unauthorized and unilateral revision of the definition of and distinctions between an "employee" and an

"independent contractor", APA members voiced serious concern with employment tax audits and assessments. This concern required in-depth research of the common law "right to control" test. From this research and analysis we have concluded that the tests enumerated in S. 736 are the most meaningful criteria.

The first three tests of S. 736 define the business relationship that must exist before a payor may avail himself of S. 736's safe harbor. The tests are tough! They embody the essence of being an independent businessman. The basic questions are, and always have been, "Do you, Mr. Businessman, run your own show?" and "Are you, Mr. Businessman, subject to all the risks of the marketplace?" and "Mr. Businessman, if you require and are utilizing a principal place of business, are you paying for it?". Because S. 736's criteria embody the essence of what it means to be a proprietor of a business, it is extremely doubtful that any independent businessman could successfully meet S. 736's substantive requirements and at the same time be an employee under the common law rule. The criteria therefore are not subject to easy manipulation or abuse by either businessmen or the IRS.

A further significant benefit of S. 736 is enhanced tax compliance. It is axiomatic that before any individual can comply with tax

obligations he must have some reasonable basis for determining the nature of those obligations. Treasury Department personnel have recently testified that a not insignificant part of the alleged non-compliance problem is simply a lack of knowledge - first of tax responsibility; second of who bears the responsibility. S. 736's first three criteria provide a clear and predictable mechanism for determining status in a business relationship - and therefore knowing one's tax obligations. They are readily capable of determination and provide an intelligent and predictable basis for decision.

Tax compliance is further enhanced through S. 736's remaining two requirements. In short, these provisions are an affirmative action tax plan. Before a payor is in the safe harbor, S. 736 mandates both a written agreement that delineates the actual relationship between the parties along with the independent contractor's tax obligations and complete compliance with existing IRS regulations concerning information returns. Taken together, these later provisions will enhance voluntary compliance and ease enforcement problems.

In summary, S. 736 answers what has been and must be recognized as the real question - who is or is not an independent contractor. It answers that question on a basis that is not only consistent

with business realities, but also consistent with equitable enforcement of and improved voluntary compliance with tax obligations. Further, S. 736's safe harbor will enable the IRS to guide its enforcement efforts to the correct port - the properly identified non-complying taxpayer. The senseless drift of those resources toward and their utilization in protracted, unwarranted, unnecessary and unproductive litigation to simply identify the taxpayer (properly a legislative matter) will end.

The IRS Compliance Study

The Treasury Department recently made public the findings of the IRS "Employee/Independent Contractor Compliance Study". APA seriously disputes the study's conclusions. It is unfortunate that the conclusions appear so newsworthy that it seems to have been forgotten that the conclusions are only as good as the study itself. We respectfully suggest that as it relates to the logging industry, the study is worthless and its conclusions should be considered of the same value.

Treasury's Compliance Study suffers critical defects in both methodology and analysis. The "Logging and Timber" category included 75 employers, resulting in 146 workers whom the IRS reclassified from independent contractor status to employee

status (Basic Tables, Vol. 1, Table 2). The employers chosen were simply employers with existing tax disagreements with the IRS, i.e., they were chosen for convenience rather than accuracy.

The following study procedure was outlined by Treasury during a phone conversation on July 12, 1979: All open examination cases involving the employee/independent contractor issue - totalling some 6,000 cases - were pulled in from the field offices. Of the 6,000 cases, approximately 2,600 were selected as being "useful". Cases considered not useful included those with incomplete data, incomplete audit information, or employer records lacking useful lists of workers. From the 2,600 "useful" cases, 50,000 to 60,000 names of workers were found. Out of the 50,000 to 60,000 names, the study targeted on 5,000-7,000 workers names, the goal being 300-400 worker names in each industry group (there were only 105 workers used in "Logging and Timber"). Rather than setting the size of the sample by the number statistically mandated to produce a valid and representative sample, Treasury allowed the sample size to be determined by budget limitations and time deadlines.

This study procedure meant that the scant 146 workers in the "Logging and Timber" category were not used in the study. Only the "useful" ones were used. At the outset, 33 workers were viewed

as "useful". The remaining 113 were sent for investigation to determine their usefulness. Those who had filed a return were considered "useful", as were those who were delinquent in filing a return and those who simply refused to file. Any worker who could not be located (26) or, albeit located, could not be contacted (2) was viewed as not useful. Even more amazing was the elimination of the 13 workers who were found at the outset to be not liable - that is, in compliance. All in all, 28.08% of the tiny group of 146 workers were eliminated from the study as not "useful" (Basic Tables, Vol. 1, Table 3). This resulted in using the following returns of workers (Basic Tables, Vol. 2, Table 4; Vol. 4, Table 5):

Initial selection	33
Delinquent Return	10
Previously Filed	50
Refusal to File	12
Total	105

Treasury justifies its elimination of 41 workers from the study by assuming those workers would all be non-compliers in any event (Lubick, Statement before Subcommittee on Select Revenue Measures, June 20, 1979, p. A-5). The 13 found to be not liable certainly do not fall in this category. More importantly, however, the assumption of non-compliance is fallacious.

It seems clear from the Format A Tables, Volume II, that the IRS was only able to reach 98 out of the 105 workers in any event. Moreover, 12 of the 105 (presumably the refusals to file) have disputes with the service other than the independent contractor/ employee issue (Format A Tables, Vol. I, Table 2, p. 59). Nevertheless, if one accepts every single assumption made by Treasury, except for the assumption that the 41 eliminated people are all tax evaders, the non-compliance rate determined by the IRS changes greatly.

The Service's own dollar figures set forth in the study bear out this likelihood. The "Logging and Timber" category shows $15,000 in income tax on unreported wages as determined by the Service (Format A Tables, Vol. I, Table 2, p. 58). Twenty-nine of the 108 returns fall in the zero tax percentage bracket. That is, when the tax percentages were applied to the corrected wages, as viewed by the Service, the tax rate was zero. In addition, the Service has set forth a zero divisor category encompassing 25 of the 105 returns. Zero divisor represents the elimination of those returns upon which it was not possible to acquire any tax bracket because of the low level of taxable income applicable to that return. While it is not clear why the two groups have been divided between the zero divisor group and the zero percentage group, nevertheless it is clear that the resulting math shows 54 out of 105 returns owing no additional taxes on reclassified wages.

In short, some of the failure to report returns listed by the IRS in its non-compliance figures must include returns upon which the tax due on the unreported "wages" was zero. Even the layman understands that the failure to report something upon which no taxes are due is an issue of little or no importance to the administration of the tax laws. Treasury has chosen to find non-compliance in a manner that will produce the most impressive figures in Treasury's opinion.

There are 50,000,000 cords of roundwood produced each year in this country, resulting in an average man-day production rate of 4.7 ("Predicted Forestry, Harvesting and Pulpwood Procurement Conditions for the Years 1980 and 2000"). This would require over 50,000 forest workers to maintain these daily production rates. The U.S. Forest Service's recent study estimating the total number of logging workers in the country, using 1972 data, places the logging industry workforce at 190,000 workers, ranging from gum gathering in the South to Christmas tree harvesting in the North. Even when the IRS sample used in the lumber and timber category is compared only to those engaged in pulpwood production, the percentages are unrepresentatively low:

IRS District	Number Workers Sampled	Calculated Total Number Workers in Pulpwood Production	Percentage Sampled
Central	8	2,200	.36%
Mid-Atlantic	2	3,300	.06%
Midwest	22	2,300	.96%
North Atlantic	9	3,500	.26%
Southeast	29	19,000	.15%
Southwest	22	8,000	.28%
TOTALS	105	38,300	.27%

As the above table shows, there are only nine individuals in the entire North Atlantic IRS district. One of those businessmen is in Maine and five are in Vermont, leaving three independent contractors to represent the huge forest industry in New England and New York. Indeed, the one individual in Maine must represent over 2,000,000 annual cords of wood production, not to mention sawlogs, veneer, and other forest products. Since we do not know very much about the individual, he or she could have been a farmer who cut one or two loads of pulpwood or logs in order to clear a pasture. Six of the individuals placed in the "Logging and Timber" category by the IRS listed themselves as farmers when questioned by the IRS agent.

The Central region, covering Michigan, Indiana, Ohio, Kentucky, and West Virginia, contains only eight workers to represent the entire area, despite the importance of the logging industry in all five of those states. It is possible, of course, that all eight representatives came from one open case.

In the Mid-Atlantic district there are only two representatives, or rather two returns, possibly constituting only one individual, representing Pennsylvania, New Jersey, Delaware, Maryland, and Virginia. Neither of the two returns involved in the Mid-Atlantic region came from Virginia, even though wood production in Pennsylvania and Virginia ranks with the highest in the country. A similar non-representative character can be found in the individuals chosen for the other regions.

One of the most glaring inconsistencies found was the Service's apparent inability to identify the businessman's occupation and industry. The field agents who did the interviews were not given any definitions to use in placing a worker in a particular industry or occupation. Rather, that determination was left to the individual discretion of each field agent. Field agents questioned as to the type of people included in the "Logging and Timber" category varied in their opinions as to who would be included. One field representative even placed treegrowers, treecutters, and saw mill workers all together in the same "Logging and Timber" category.

Only 91 of the 105 used in the logging and timber sample agreed with the Service that they belonged in the logging and timber industries. Two placed themselves in real estate, one in direct

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sales, six in other sales, two in the trucking industry, one in the home improvement business, one in an unidentified "other" category, and one simply didn't know what industry he was in (Format A Tables, Vol. I, pp. 49-50).

In short, the study utilized a non-representative sample, invoked unorthodox methods, and was analyzed to an apparently predetermined desired result. This Association knows its members. We would welcome an accurate study because we know that the results of a properly operated study would result in a finding of high compliance.

The Withholding Proposal

After review of Treasury's study and its proposal we were somewhat surprised. We believe that both the study and the proposal vindicate the position that businessmen in logging had taken while under audit and are taking today. There is not a hint in either the study or the proposal that those reclassified in audits were employees or should be treated for tax purposes as employees. Nor is there a hint that those Treasury terms "workers" are employees. In our opinion, the study and proposal prove that the IRS activities concerning employment taxes in the logging industry were unmerited. One receives the distinct impression that the common law rule was purposely abused. Legitimate businessmen were audited and assessed

(harassed) without basis in fact or law to achieve a result that bears no relation to the employment "problem" when that problem is accurately defined.

What is the net result of Treasury's proposal? Does it simplify the tax collection or enforcement process or provide greater clarity to businessmen? The answer is no! The net result is increased and perhaps more serious confusion by simplistically and mechanically ignoring economic facts and creating yet another (a third) layer of business relationships - that of the "withholding" independent contractor. If Treasury's proposal were to be implemented, business would face the problem of deciding among employee, independent contractor, or "withholding" contractor. Given the confusing IRS "guidance" in the recent past, we can only envision further contradictory rulings and misdirected litigations.

In addition to needlessly complicating tax law, Treasury's proposal is an economic disincentive, unnecessary, unduly burdensome, and unworkable.

Because the outlines of Treasury's withholding proposal are sketchy, it is difficult to measure its precise impact on the logging industry. However, the following are distinct

possibilities that reflect the absurdity of Treasury's proposal, any one of which could lead to the demise of the small logging businessman:

1. Loggers may have to withhold on payments made to gas stations, parts or supplies vendors, repair services, and the like or receive from each supplier a properly marked exemption form. This is needless, stupid paperwork.

2. Loggers may have to withhold on payments to landowners for the landowners' timber or receive an exemption form.

3. Loggers are not only payors, they are payees. They may sell their products or services directly to a forest products manufacturing plant or to a wood broker. Depending upon the supply system, the withheld-upon logger may receive a twenty to thirty percent reduction in gross revenues - more than enough to bankrupt any business.

4. Treasury notes an advantage to the payor - the use of the payee's money pending its payment to the government. This will probably make withholding inevitable, regardless

of the payee's protestations. First, withholding may be the "safest" alternative. Second, most systems run more effectively when no exemptions exist. Third, the payor makes money. Although we realize big business has major capital availability and formation problems, we strenuously object that their return on investment be improved by disrupting and devastating the cash flow of, and potentially bankrupting, small logging businessmen.

5. Flat rate withholding on a gross amount paid bears no relationship to business realities in the logging industry. The amount paid is not profit. In fact, depending on market conditions, it may involve a loss. From amounts paid to him, a logger must pay his employees, pay landowners, pay for equipment, meet the costs of repairs, supplies, fuel, lubricants, and insurance (all the normal costs of operating a business). The sole alternative for a logger to stay in business is universal exemption (if the payor will agree), or exemption on a delivery by delivery basis (also if the payor will agree).

   A flat withholding rate ignores variances in profit margins; a graduated rate requires a transaction by

transaction estimation of tax liability, producing for the small business an overwhelming paperwork burden. The choice, then, is between financial ruin for low profit margin businesses (flat rate system), and an impossible paperwork burden for the small business (graduated rate system).

6. No one to date has been able to accurately estimate the cost of complying with federally mandated regulations. The estimates that do exist run into the billions of dollars. In terms of the small logging businessman, withholding may be the straw that breaks the camel's back. In addition to the purposeful loss of the use of his money, he would have to keep track of exemption forms he has signed, exemption forms his payees have signed, the amounts withheld on payments made to him if he failed to get or could not get an exemption, amounts he withheld on payees for whom he lacks an exemption form, the many returns we are certain ultimately must be a part of this proposal in order that Treasury, at least, can make some sense out of it, and the deposits to be made, plus making certain they are made properly. Unfortunately, we are not aware of a computer for "in-forest" use. Although

our fondness for tax attorneys and accountants is normally unbounded, there is a limit. Unfortunately, the logical alternative may simply be to either leave the business or not to go into the business in the first place.

We urge that the most effective means of enhancing tax compliance is not mandatory withholding in economic relationships where the entire concept of withholding is absurd, but rather S. 736. Knowing definitely who has the obligation to pay coupled with improved information reporting and enforcement directed at the proper party will significantly improve compliance. Such a solution is vastly preferable to a solution that totally disregards business realities.

Support for the Common Law

A major part of our support for S. 736 is based upon the fact that it does not supplant the traditional common law test. Our initial support of S. 736 stemmed from a sense of security provided by the additional certainty to be found in adding alternative safe harbors to the long-standing common law test of an independent contractor. S. 736, then, is an improvement on status determination. It does not disrupt decades of tax status development - a development upon

which the great bulk of economic relationships have been established. Rather, S. 736 would amend the tax laws in a way that merely reduces the amount of money spent to resolve status disputes with the IRS.

As we noted earlier, we would not support any legislation that would completely replace the common law as the appropriate test for determining employment tax obligations. Further, we would not support a safe harbor coupled with any provision that denigrates the status of APA's members as legitimate and honest self-employed businessmen - as would be the case with Treasury's flat rate withholding proposal.

Contrary to Treasury's belief, the common law is not an Anglo-Saxon jurisprudence anachronism without meaningful application to today's question and tax issues generally. The test is flexible. We recognize that this flexibility may produce a minorly irregular pattern as new and novel business relationships arise. However, it is precisely that flexibility that permits the test to meaningfully and predictably judge the nature of the relationship between parties in new and novel economic situations.

An additional attribute of the common law test, which is not merely desirable, but essential in most tax matters, is its

neutrality. In a dynamic, free enterprise economy it would be tragic to have the tax code impair or interfere with the decision-making process between and among business parties.

In the long run, Treasury's short-sighted and simplistic view will curtail economic activity and ultimately impact negatively on government revenues. Assets will not be utilized to their fullest. New independent entrepreneurial activity may diminish because there will exist a strong bias to create "employment" relationships. It will be the only "safe" tax alternative.

The Employment Tax Laws Can Be Enforced

The common law rule imposes no additional enforcement burden upon the IRS when reasonably applied. There has never been a problem in the woods in determining whether or not one individual was employed by another. The IRS problem is of its own making.

We know that the employment tax laws can be enforced. We know that independent contractors can be found, and their tax obligations determined and appropriate action taken.

IRS enforcement activities with respect to independent loggers are being undertaken today in two regions: an eight county area of northeastern Florida and a sixteen county area of western Penn-

sylvania. IRS personnel have informed us that such "collection" activities are routine. Although our analysis has shown that the Treasury compliance study proves little, there is one fact that it does prove rather conclusively - IRS has the means and the resources to identify and find independent businessmen who are evading their tax responsibilities. Even assuming a remote degree of validity to the compliance study, are we not left to wonder what compliance characteristics would be had the IRS' enforcement resources been directed initially at the proper taxpaying parties? The recurrent Treasury theme, that IRS lacks both the means and the resources to enforce the tax laws on payments made to individuals who are self-employed is without merit.

We do agree with Treasury that lack of knowledge and complexity may play a significant role in tax collection problems. Over a two year (1976-1977) period and in cooperation with the IRS and the Social Security Administration, APA carried out an extensive information and education program to help logging businessmen know their proper tax obligations. The effort involved hundreds of meetings on virtually a county by county basis in numerous forested states. We know this joint effort generated admiration, respect, and appreciation for the Internal Revenue Service and improved already excellent compliance. APA is as ready to help in this effort today as we have been in the past.

Proper enforcement directed toward the true taxpayer, education, and improved information reporting will advance compliance significantly more than a rashly conceived withholding proposal.

Conclusion

S. 736 is the solution to the real problem before us today. It brings predictability and clarity to an area that has been made unnecessarily confusing. It will enhance tax compliance without supplanting the common law test and without disturbing economic relationships of proven efficiency and workability.

The withholding proposal must be rejected. The proposal is not realistic, and demonstrates an abysmal ignorance of the business and economic relationships underlying this country's capitalistic system. Treasury's withholding proposal will be the death knell for the small independent logging businessman.

APA fully supports better reporting and will continue its efforts to make sure those in our industry know their proper tax obligations. Finally, we respectfully suggest that the severe "role reversal" problem Treasury has initiated be curtailed. It is time to make sure that the code eases the burden of self-employed businessmen who creates the revenues upon which this government thrives, rather than forcing businessmen to revise viable economic structures to ease minor administrative burdens.

SENATE FINANCE COMMITTEE

TESTIMONY ON

S. 736

A BILL TO AMEND THE INTERNAL REVENUE
CODE AND TO CLARIFY THE STANDARDS
USED IN DETERMINING WHETHER AN
INDIVIDUAL IS AN INDEPENDENT CONTRACTOR

TESTIMONY OF
NATIONAL ASSOCIATION OF HOME BUILDERS

My name is Fred Napolitano. I am a resident of Virginia Beach, Virginia, an active home builder and appear today on behalf of the National Association of Home Builders ("NAHB"). NAHB is the trade association of the housing industry of the United States. Our membership, engaged in the building of the homes of America, comprises more than 100,000 members and more than 300 local associations situated throughout our country.

The membership of NAHB is vitally and directly affected by the concerns which are the subject of S. 736. The ambiguities in present law concerning the distinction between an employee and an independent contractor have long been a source of Internal Revenue Service inquiry of home builders. Often, this entails a time consuming, expensive and, we believe, needless tax audit controversies.

NAHB, therefore, shares fully the concerns of Senator Dole and, for that matter, the Treasury Department in resolving the independent contractor-employee issue. At the same time, this Committee must be fully aware of the special needs of the housing industry in relation to these problems.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades, and because such job site necessarily changes as the homes are built, the relationship between the home builder and the person who performs the different trades varies widely in this industry. For example, a

bricklayer uses as his principal tools only a hod and a trowel. The bricks are, of course, supplied directly by the home builder and this cost far exceeds the cost of the tools.

Another complicating factor, principally from the standpoint of the approach which the Internal Revenue Service has made to many home builders, is the fact that a home builder may find it advantageous to "sub out," that is, to hire an independent contractor to perform services which may, in the minds of many, particularly the Internal Revenue Service auditing agent, may constitute performance of "common labor." In that instance, and largely because of this, the Service often alleges that the persons performing those services are employees rather than independent contractors.

For example, a home builder may hire an individual who with his own employees performs the principal task of "clean up man." He, and his co-workers, go to the job site to eliminate the clutter at the conclusion of the principal construction. No special tools are required; no special

skills are involved. Yet the home builder not only prefers, but often must, deal with that person on an "independent" basis looking to him only for the completed job. The fact that such a person is required to be on the job site at a certain point (following the completion of other aspects of construction) and at that point the construction may also be fixed by reference to time, i.e., at a certain day at a certain hour does not, from the standpoint of the home builder, suggest that the time of that individual, hour by hour, is directly under his control.

This same point can be made with respect to other trades. Here are a few examples: The person responsible for the flooring of a home must complete his work before the person doing the framing arrives on the job. The framers, in turn, must complete their work before the electricians or those installing sheet rock arrive. And so on. Thus, although the builder does not specifically control the hours of work of the subcontractor, he must, in fact, schedule the date of commencement and often the date of completion of the work so that the house may be built in a logical and efficient sequence.

Another issue concerns the principal place of business. In the case of a subcontractor for a home builder, this may be ambiguous. For example, a masonary contractor maintains a form of office on the job site. Sometimes this is in a truck owned by the contractor or the building. On other occasions, he may utilize a desk provided rent free by the builder on the job site. Under S. 736, such an individual may be regarded as maintaining a principal place of business which has been provided by the person for whom the service is performed. In that event, his independent contractor characterization is jeopardized.

For the foregoing reasons, NAHB recommends that S. 736 be modified in the following respect:

1. In situations, such as in construction, where work must necessarily be performed on a job site in sequence, that a builder will not be deeemd to control the hours worked, notwithstanding that time limits or date limits may be placed upon completion of a job. A subcontractor will not be considered to maintain a principal place of business if he performs substantially all of the services at a single fixed

location provided by the builder, if that location changes from time to time as jobs are completed;

2. An individual will be deemed to have a substantial investment in assets in connection with performance of services without regard to the cost or value of the assets in relation to the value of the services which he performs; and

3. Where the tests outlined in S. 736 are not met, the common law rules would apply and no inference would be drawn as to the individual's status as a result of the failure to meet the statutory tests. This would be consistent with the bill's intent of clarifying the standards presently used and not replacing them.

With the modifications above noted, and doubtless others will be suggested as a result of these hearings, NAHB feels that the enactment of S. 736 would constitute a major step towards elimination of needless tax audits and expense, all of which factors now confront home builders with respect to the independent contractor v. employee issue. On the other hand, I must state to you emphatically that we oppose the withholding proposal of the Treasury. The flat 10 percent withholding tax appears to us to represent an attempt by the

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Treasury to shift the burdens of tax compliance from the Internal Revenue Service to the operating home builder. That person typically is the small businessman. Most produce less than 50 houses a year. Most -- simply because they are, in fact, general contractors utilizing independent third persons for much of the work -- engage very few persons as direct employees. The average is 3 or 4 nationwide. Additional record keeping requirements are erroneous and the Treasury approach materially adds to the cost. These costs may, indeed, be greater than those which would be entailed in a careful and conscientious administration of present law as modified by S. 736.

NAHB fully supports the proposition that every American must pay his full share of federal income tax. Because we do not have access to the revenue statistics which are available to the Treasury Department, we cannot dispute the allegations of loss of revenues through noncompliance by independent contractors. If this problem exists, it is the job of the Internal Revenue Service to solve it on the basis of clear and uniformly applied law. We suggest that S. 736 as proposed and proposed to be modified reaches this result. We, therefore, recommend its adoption.

September 17, 1979

Senator BYRD. The next piece of legislation to be considered is S. 1514.

S. 1514 was introduced by Senator Warner and myself. Senator Warner is very interested in this legislation and he will be here at the earliest opportunity. He is now in a very important meeting.

This panel will consist of Mr. Thomas R. Casberg, Deputy Director, Directorate of Construction Standards and Design, Department of Defense; Mr. John Millhone, Director, Office of Buildings and Commercial Systems, Department of Energy; the Honorable Patrick L. Standing, mayor of Virginia Beach, Va., and chairman of Southeastern Public Service Authority of Virginia, accompanied by Mr. Durwood S. Curling, executive director of Southeastern Public Service Authority and Richard Chirls, Esq., and Mr. Robert H. Aldrich.

Also, Miss Caroline Konheim, program manager, Combustion Equipment Associates, Inc.

All of you are most welcome.

Mr. Casberg, I guess you would want to start off.

Senator CHAFEE. Mr. Chairman, if I might.

As I understand it, they will not go into the legislation, just what it does. Could somebody just give us a brief synopsis of what the legislation does? As I understand it, tax-exempt industrial development bonds can be used for solid waste disposal facilities, but if a Federal entity uses it, then there is a possiblity of losing the exemption.

In other words, if you have one in Newport News and the Federal Government uses part of it, say a naval facility uses it, then it puts the entire issue into jeopardy. Is that the problem?

Senator BYRD. That is correct, Senator.

If I understand it correctly, Senator Chafee, if the electricity, the energy, was to be sold through a private company, then there would be no problem. Is that not correct?

Mr. STANDING. That is correct.

Senator BYRD. It is just because the Navy would purchase some of the energy that it requires additional legislation.

Senator CHAFEE. We are talking about a situation where the Navy, to stick with the analogy, the Navy does not take 100 percent, just 20 to 25 percent. Is that right?

Mr. ALDRICH. It must be a substantial portion going to a Federal facility.

Senator CHAFEE. What is that?

Mr. CURLING. The IRS has not clarified that rule in excess of 50 percent.

Senator CHAFEE. In excess of 50.

Mr. ALDRICH. Of the total revenues.

Senator CHAFEE. I see.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, Senator Chafee.

I believe at this point that it might be helpful to read a letter which I just received, as chairman, from the Department of the Navy. It is a two-paragraph letter which I will read into the record.

For a number of years, the Southeastern Public Service authority of Virginia, which represents some six Tidewater communities, has been endeavoring to develop

a Southeast Tidewater Energy Plant, fired by municipal waste, which would provide the Norfolk Naval Shipyard with steam and electric service.

The project takes on added significance in view of the country's present and long-range energy outlook. It is of particular interest to the Navy, because it would make one of our principal shipyards almost independent of fossil fuels for steam and electric energy.

Alternately, the shipyard is currently faced with the prospect of spending large sums of money to replace its existing aged and unreliable steam and electric power plant. The technical feasibility of the project has been established and its economic viability is currently being evaluated.

Our economic analysis has been predicated on the use of tax-free bonds. If the bonds should become taxable, the project would unquestionably lose its economic viability and further deliberations would be unwarranted. With tax-free bonds, it may be difficult to solve the complex economic problems associated with producing steam and electricty from refuse.

It seems to me that that is a rather significant letter from the Department of the Navy. I might say before we begin these hearings that I am not one to advocate extended use of tax-free bonds. As a matter of fact, I disapprove of some of the uses to which tax-free bonds have been put.

But we are dealing, in this situation, with six or seven different municipalities. Those municipalities would have no problem, except for the fact that the Navy is involved.

If this project is not deemed economically feasible because of the change in the tax-free status as I judge from this letter, the Navy would have to come to the Congress for an appropriation of tax funds to take care of their problems in the Norfolk Naval Ship Yard.

Gentlemen, this should be your time. You may go ahead.

Senator CHAFEE. Mr. Chairman, did Mr. Lubick testify on this?

Senator BYRD. The Treasury has submitted a written statement that will be inserted in the record. The Treasury Department, at the moment, does not approve the legislation.

However, the representatives of the Treasury Department will meet Friday with representatives of this group in an endeavor to work out some of the problems that the Treasury Department sees in the way of a precedent that might be established.

I would want the record to show that the Treasury Department, as of now, does not approve of the legislation which is before us.

Mr. Casberg?

STATEMENT OF THOMAS R. CASBERG, DEPUTY DIRECTOR, DIRECTORATE OF CONSTRUCTION STANDARDS AND DESIGN, DEPARTMENT OF DEFENSE

Mr. CASBERG. Mr. Chairman, I am Thomas R. Casberg. I am responsible for utilities and energy engineering in the Office of the Deputy Assistant Secretary of Defense for Installations and Housing.

I am pleased to appear before the committee today to represent the Department of Defense with regard to S. 1514. I have with me today Mr. Charles M. Rieder, Director of Utilities Acquisition of the Naval Facilities Command.

I have no formal statement for the record, Mr. Chairman. I would like to make a couple of brief remarks.

Since S. 1514 relates to utilities, I would like to note that the Department of Defense, therefore, has an interest in this matter.

For many years, we have devoted considerable effort to reducing our annual utilities bills. Since the oil embargo, we have doubled our efforts, and our objective has always been to obtain utilities services at the lowest possible cost.

In addition to reducing costs, we are striving to use less oil and natural gas. Where we can use noncritical fuels at a lower total cost, this is being done.

The proposed project by the Southeast Public Service Authority is of interest to us because it generates steam and electric power from waste products, and the initial indications, at least several years ago, were that it might supply these utilties at a cost savings to the Navy.

Recent information indicates that costs have risen, and I believe that the question of economic feasibilty is still under review.

We have remained interested in the project, assuming that it would result in a cost savings to the Department of Defense. With regard to the specific language of the bill, we would defer to the Treasury Department. With regard to the administration's position on the bill, we would defer to the Department of Energy.

Mr. Rieder and I would be pleased to answer any questions that you may have.

Senator BYRD. Thank you, sir.

Mr. Millhone?

STATEMENT OF JOHN MILLHONE, DIRECTOR, OFFICE OF BUILDINGS AND COMMERCIAL SYSTEMS, DEPARTMENT OF ENERGY

Mr. MILLHONE. Mr. Chairman, I have a statement that I will ask to be submitted into the record. However, I think that my oral remarks can be quite brief and to the point.

Senator BYRD. The statement will be published in full, and then you can summarize it.

Mr. MILLHONE. I think that the issue on this bill has been well stated in your preliminary discussions. My statement identifies the concern that the Department of Energy has for using the valuable energy resource that is posed in urban waste.

By 1985, the Nation will be discarding 200 million tons of municipal waste a year. This represents a potential energy resource of two quads.

If all the energy-intensive materials, such as steel, aluminum, glass and certain paper fibers were recovered and recycled, we would conserve an additional one quad of energy.

However, it is not expected to be able to recover all of these. All of these estimates, at the current level of technology are at the range of 55 percent, so we are dealing here with a subject matter that are of great concern for the Department of Energy in terms of getting these kinds of facilities moved ahead and on-line.

The Department of Energy has research and development going on in this and related areas. My statement covers those in some detail. I do not think it is necessary to go into that at this time.

The bill, as you know, provides that industrial development bonds issued by tax-exempt State or political subdivisions may be used as a means of financing solid waste facilities where the steam

or electric power produced by such facility is used by the Federal Government.

One of the opportunities for using this is proposed as the recovered plant at Norfolk, Va. This is an attractive project for us in that it combines cogeneration and would be the first such facility in the United States.

Senator BYRD. This would be the first such facility in the United States?

Mr. MILLHONE. The first cogenerating facility.

So that we see it as a significant, major facility and attractive to the mechanisms that would make it possible to proceed further with it.

However, this specific language deals with issues that are more properly the concern of the Internal Revenue Code and the Treasury Department, so that the Department of Energy would defer to Treasury for any specific comments on the bill before you.

Senator BYRD. Thank you, sir.

The committee is pleased to have the distinguished mayor of the city of Virginia Beach with us today.

STATEMENT OF HON. PATRICK L. STANDING, MAYOR, VIRGINIA BEACH, VA., AND CHAIRMAN, SOUTHEASTERN PUBLIC SERVICE AUTHORITY OF VIRGINIA, ACCOMPANIED BY DURWOOD S. CURLING, EXECUTIVE DIRECTOR, SOUTHEASTERN PUBLIC SERVICE AUTHORITY OF VIRGINIA; RICHARD CHIRLS, AND ROBERT H. ALDRICH

Senator BYRD. Mayor, I believe that Virginia Beach is probably one of the fastest growing major cities of the United States, is it not?

Mr. STANDING. That is correct, Senator, and it is a pleasure for me to be here today. Virginia Beach is the fastest-growing city east of the Mississippi, third in the United States, with a present population of 275,000 people.

Senator BYRD. The population is 275,000.

Mr. STANDING. 275,000.

Senator BYRD. When do you expect to hit 300,000?

Mr. STANDING. It will be the largest city in the State in the next year or so, certainly before the next census takes place.

Senator BYRD. Incidentally, you succeeded a mighty good man as mayor—Mayor Holland. I worked closely with him, and I would like to work closely with you also.

Mr. STANDING. We are fortunate that we still have him on our council.

Senator, since you covered, and Senator Chafee covered, many of the questions in my statement, I have submitted a statement to you that I would like to incorporate in the record.

Senator BYRD. That would be published in the record.

Mr. STANDING. If you would agree with all of those things, I could just get up and leave.

The Public Service Authority is a political subdivision of the State of Virginia. It does comprise six cities, Virginia Beach, Norfolk, Chesapeake, portions of Franklin and Suffolk, and two counties, Isle of Wight and Southampton.

In those six cities and two counties, there are approximately 800,000 people. I am sure that you are aware that very few times have those six or eight political subdivisions ever agreed on any one particular thing, but I come to you saying that all eight are members of the Southeastern Public Service Authority in 1974. All recognize the real concern for solid waste.

In laymen terms, that is mostly garbage.

At the time that we recognized the problem with solid waste that was being landfilled—and it still is being primarily landfilled—the U.S. Navy also had a problem with its electrical and steam-generating capacity at the Norfolk Naval Shipyard, which is in Portsmouth.

So after various studies, our engineers and consultants have determined that refuse-derived fuel would be a major means and would be a solution to the joint problems of localities and the U.S. Navy.

To do this, of course, the localities have spent a considerable amount of their own funds, totaling $2.2 million at this point to complete the studies and to do approximately 30 percent of the design for the facility.

The authority also has applied for, and received, the required air emissions permit from the Environmental Protection Agency and has submitted an environmental impact statement.

The U.S. Navy has been very helpful throughout this entire process and, at this point, with our computer models of cost we, working with the Navy, are preparing the utilities contract to provide them with steam and electricity.

I think it is important also to note that today the U.S. Navy is using 800,000 barrels of fuel oil to produce the steam and electricity that is required at their facility.

Senator BYRD. Excuse me; 800,000 barrels at the Norfolk Naval Shipyard?

Mr. STANDING. That is correct, to produce steam and electricity.

Senator BYRD. If your proposal is approved, much or all of that would be obtained from urban waste?

Mr. STANDING. From burning garbage, yes, sir.

Senator BYRD. It seems to me that that is a real breakthrough and is helpful not only to the six municipalities and two counties involved, but also to the Navy and to the Nation as a whole.

Mr. STANDING. It even goes further than that in that you have already mentioned the fact that their facility there, to produce steam and electricity, is almost completely dilapidated and they freely admit that, and their alternative to us, providing them with steam and electricity based on their own figures is an appropriation by you of almost $100 million to build them a new facility. And that system could not provide the redundancy in the system we are providing and the steam we would be providing them.

Senator BYRD. Let me interrupt you again, just to be certain I understand.

You say the Navy is using 800,000 barrels of oil?

Mr. STANDING. That is correct.

Senator BYRD. That would be eliminated if this were enacted?

Mr. STANDING. That is correct, Senator.

The Navy, of course, has a purchase contract from the General Electric & Power Co. at present to provide them with electricity. The 800,000 barrels includes what they are burning at their plant to provide the Navy with electric energy.

Senator BYRD. Thank you.

Mr. STANDING. The computer model that we have developed indicates that over the life of the project, which is a 30-year life, based on the bond, the Federal Government, that is, the U.S. Navy, would realize a savings from this project of $400 million.

Senator, that is, of course, the reason that we are supporting the legislation to solve a local problem of solid waste disposal but in this particular case, we have, I think, the enviable situation where we can, in cooperation with the U.S. Navy, provide them with something they need and also bring to the attention of all of the United States and the world in the last 5 years the energy problems and the reliance by the U.S. Navy on fossil fuel, and that that would be almost completely diminished by this project.

Thank you.

Senator BYRD. Ms. Konheim?

STATEMENT OF CAROLYN S. KONHEIM, REPRESENTING COMBUSTION EQUIPMENT ASSOCIATES, INC.

Ms. KONHEIM. I am representing the Combustion Equipment Associates which designs, builds, owns and operates resource recovery plants which convert refuse from solid municipal waste into a high Btu synthetic fuel, ECO-FUEL II through a proprietary patented process.

ECO-FUEL is sold on a Btu basis to electrical utilities as a substitute for oil or coal.

We have been able to establish long-term purchase contracts with utilities which include: United Illuminating Co. in Connecticut, Public Service Gas and Electric Co. in New Jersey, New England Power Co. in Rhode Island and a half dozen others who have signed either letters of intent or preliminary agreements.

ECO-FUEL will be burned at United Illuminating in Bridgeport, Conn., next week.

As part of CEA's contracts with the utilities, we construct onsite fuel receiving, storage, and fuel feed facilities. CEA's contract covers any necessary upgrading of air and water pollution controls and ash removal equipment. As with any refuse derived fuel process, these energy conversion facilities are an integral part of our resource recovery system.

While CEA's current projects are not utilizing industrial revenue bonds, this possibility should not be precluded for future financing. The restrictions of S. 1514, therefore, are of concern to us.

As introduced, S. 1514 disallows tax-exempt status to energy conversion portions of a solid waste disposal system if they are not contiguous to the disposal facility. This is strongly discriminatory against virtually all refuse derived fuel processes in which the refuse processing facility is rarely located next to the fuel user.

The flexibility of optimally siting plants according to environmental, traffic flow and other land use needs is their very advantage. While the utilization of existing powerplants normally re-

duces the overall disposal cost to the community, such plant sites rarely have room to accommodate a new processing facility.

Only one category of technology qualifies under the proposed language: Incinerators which produce steam which is used for heat and/or electricity. Assigning tax advantages to the vendors of these processes gives them an undue advantage in financing resource recovery plants.

Therefore, we urge deletion on page 2, line 6, of the words "and which is located at the same place as, or adjacent to, a solid waste disposal facility."

Additionally, S. 1514 is restricted to plants which are publicly owned or controlled. In much of this country, waste collection is managed by private concerns. Even in New York City at least 30 percent of the waste is collected by private carters. Disposal may be in publicly or privately owned landfills, incinerators or processing plants.

All public policy is directed to encourage private financing of refuse processing facilities. Virtually no capital grant funds are available.

The magnitude of available solid waste and the increasing energy revenues are attracting private developers to assume the risk of financing resource recovery projects without prior contracts with governmental agencies responsible for waste disposal. CEA/OXY has done this in Newark, N.J., and will do so at two sites in New York City. These projects are able to assure a waste supply by offering disposal at reasonable costs to surrounding communities and private waste haulers. The reasonable costs is aided by structuring the projects to optimize advantages to taxable and tax-exempt entities.

Therefore, we urge that S. 1514 be modified to delete page 2, line 3, the words "operated by or on behalf of the governmental unit." Failure to do so thwarts private initiative in solving the solid waste problem and increases the passthrough of higher financing costs to the public.

CEA commends the Finance Committee for taking steps to encourage turning our pressing solid waste problem into a meaningful source of renewable energy. We feel certain that it was not the intention of the committee to discriminate by technology or to discourage private investment and that recognition of these provisions can be easily corrected.

Senator BYRD. Thank you.

Let me say first, in reading the letter from the Navy I do not believe I stated that it was signed by Rear Adm. C. C. Hied, U.S. Navy, Commander, Atlantic Division, Naval Facilities Engineering Command.

[The letter referred to follows:]

DEPARTMENT OF THE NAVY,
ATLANTIC DIVISION,
NAVAL FACILITIES ENGINEERING COMMAND,
Norfolk, Va., September 14, 1979.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: For a number of years, the Southeast Public Service Authority of Virginia (SPSA), which represents some six Tidewater communities, has been endeavoring to develop a Southeast Tidewater Energy Plant, fired by municipal

waste, which would provide the Norfolk Naval Shipyard with steam and electric service. The project takes on added significance in view of the country's present and long range energy outlook. It is of particular interest to the Navy because it would make one of our principal shipyards almost independent of fossil fuels for steam and electric energy. Alternatively, the shipyard is currently faced with the prospect of spending large sums of money to replace its existing aged and unreliable steam and electric power plant.

The technical feasibility of the project has been established and its economic viability is currently being evaluated. Our economic analysis has been predicated on the use of tax free bonds. If the bonds should become taxable, the project would unquestionably lose its economic viability and further deliberations would be unwarranted. With tax free bonds, it may be possible to solve the complex economic problems associated with producing steam and electricity from refuse.

Sincerely yours,

C. C. HEID, *Rear Admiral, Commander.*

Mr. STANDING. I failed to indicate tha, with me today is Mr. Robert Aldrich and Mr. Durwood Curling and Richard Chirls and they have a comment that they would like to make. Mr. Aldrich would like to make the first comment.

Mr. ALDRICH. Senator, is that appropriate?

Senator BYRD. Yes.

Mr. ALDRICH. I am Bob Aldrich, along with Charley Meacham, an investment corporation in Virginia. We are working along in developing the financing for this particular project down in that area.

Our company, Payne, Webber & Curtis provides investment banking services to States and communities throughout the Nation for solid waste management problems, particularly for facilities that convert waste into usable energy and recover valuable raw materials, such as iron and glass, et cetera.

Municipal waste facilities are beneficial to the whole economy. Locally it solves serious garbage disposal and landfill problems, while also providing new facilities or creating new employment and it provides a new and reliable source of energy for our community, and that can be up to 10 percent of the community's electrical needs, for example.

Nationally, it solves a major environmental problem and potentially displaces $220 million barrels of imported oil per year of which the Virginia project, as you saw, would be of the first and one of the leaders in this particular area.

We expect to achieve, as the Department of Energy implied, some 50 to 60 percent of these.

This market has not developed, or this industry has not developed, as rapidly as we would like to see it due to uncertain environmental regulations, legal constraints, marginal economics of such facilities and, last but most important to your bill, uncertainties about the mechanisms by which such facilities are to be financed.

The value of S. 1514 is one that would recognize that the communities have used taxes and financing for such facilities; two, it recognizes the economic need of tax-exempt financing for such facilities; three, it recognizes that local government and private industry must work together in the development of resource recovery facilities.

Four, it clarifies the question of what facilities can be financed using tax-exempt bonds. That is more consistent with actual practice than the existing Treasury regulations.

Last, it permits Federal facilities using energy from raw waste to be financed using this technique.

The savings to the community are substantial. The savings to Virginia is approximately $5 million a year utilizing the former financing under your legislation.

Thank you.

Senator BYRD. Thank you.

I have a letter from the mayor of Portsmouth, Richard J. Davis, endorsing this legislation which I will put in the record at this point.

[The material referred to follows:]

[Mailgram]

PORTSMOUTH, VA., *September 12, 1979.*

HON. HARRY F. BYRD, Jr.,
U.S. Senate, Washington, D.C.

DEAR HARRY: As you well know, the Senate Finance Committee's Subcommittee on Taxation and Debt Management, which you chair, will be conducting a hearing regarding S.B. 1514 on Monday, September 17, 1979. This bill, which attempts to clarify and alter IRS regulations regarding such energy saving projects as Tidewater's regional solid waste facility, is extremely important to this Nation's effort to obtain energy and independence.

We have resolved locally that it is in the Nation's and Tidewater's best interest to work with the Department of the Navy in order to reduce their dependence on oil at the Norfolk Naval Shipyard. The energy independence obtained through the use of private and municipal refuse will greatly add to our national energy program while at the same time resolving the ever increasing local burden on refuse disposal.

S.B. 1514 will authorize the issuance of tax-free bonds in order to finance this project. During the early years of this project such assistance is necessary in order for the project to be economically feasible, certainly, from a practical standpoint there can be no better example of a project designed for public benefit.

As a member of the regional commission of elected officials appointed to oversee this project, and as mayor of the city of Portsmouth, I urge you to endorse this effort so this project can at last be brought to a successful conclusion. Your assistance to date has been essential, and it is hoped that your strong personal interest will continue.

Sincerely,

RICHARD J. DAVIS, *Mayor.*

Senator BYRD. Also, I have a letter from Mr. J. B. Crawford, chairman of the board and president of the UOP Inc., world headquarters in Illinois. I will put that letter in the record.

[The material referred to follows:]

UOP INC.,
Des Plaines, Ill., September 12, 1979.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: In the near future the Senate Finance Subcommittee on Taxation and Debt Management will hold hearings on your Bill S. 1514 concerning solid waste disposal facilities. UOP Inc. is actively involved in the construction and operation of solid waste disposal facilities which, in modern disposal systems, includes as an integral part thereof the generation of electricity.

As you have pointed out, solid waste recovery facilities are important since they address two problems facing our Nation—environmental concerns in disposing of solid waste and production of energy. Solid waste recovery facilities are capable of reducing our dependence on foreign oil by turning what was a problem—disposal—into an asset—energy. A ton of solid waste can generate approximately the same amount of electricity as a barrel of oil. If this "new resource" were fully utilized, the annual importation of 200 million barrels of oil—or more—could be eliminated.

Municipalities across our country are facing the disposal problem and, incidentally, helping to solve the energy problem. One of the most important aspects they face in these efforts involves financing. Your Bill addresses this problem.

In a major solid wast facility, construction costs can exceed $100 million so, obviously, tax-exempt financing improves the economic viability of the project. However, as you have pointed out, current Internal Revenue Service interpretations limit tax-exempt financing only to the solid waste portion of the disposal facility and excludes the electric generating equipment which, in projects which include electric generation, is an integrated part of the total disposal system.

We are entirely in agreement with the concept in S. 1514, but recognize that the Bill was originated to cover municipal financing problems similar to the Tidewater, Virginia project. It would be very disappointing if your proposals do not benefit other public interest solid waste projects because future interpretations limit application to a narrow factual pattern similar to the Tidewater, Virginaia project.

One major technical aspect of Bill S. 1514 which we would like to see clarified is the requirement that the facility which produces the gas, heat or energy must be "operated by or on behalf of the governmental unit". By definition, Industrial Development Bonds finance private projects and the general exception for solid waste disposal facilities applies to Industrial Development Bonds. Since it does not appear that it is intended to add any additional rules under Industrial Development Bonds, the "by or on behalf of" phrase is unnecessary.

UOP Inc. strongly supports your effort to expand the definition of Solid Waste Disposal Facility. We recommend, however, that the language of your Bill not be restrictive to preclude municipalities from undertaking such projects since the electric generation portion of such projects are not operated "by or on behalf of the governmental unit" and, therefore, the economic viability of the project is adversely affected.

Sincerely,

J. V. CRAWFORD,
Chairman of the Board and President.

Mr. CHIRLS. Mr. Chairman, I am Richard Chirls, associated with the law firm of Brown, Wood, Wise, Mitchell & Petty in New York. We represent the Southeastern Public Service Authority of Virginia as bond counsel and we wish to testify in support of S. 1514.

As you are aware, tax-exempt financing is presently permitted under the Internal Revenue Code for the financing of solid waste disposal facilities. Congress has therefore stated its present intention to permit tax-exempt bonds to be used for such purposes.

Therefore, S. 1514 does not serve to open up a brandnew loophole.

Senator BYRD. I might say if it did, this Senator would not have ever introduced it, because I do not believe in expanding the tax-exempt bonds, as you say. This is a part of existing law.

The problem it has raised, that the energy will be sold to a Government unit, namely, the U.S. Navy, that has caused a problem. Is that not correct?

Mr. CHIRLS. That is correct. The problem has arisen because of the interpretations proposed by the Treasury and the Internal Revenue Service on the use of tax-exempt bonds that has restricted their use in this particular instance and perhaps the use by other projects.

Senator BYRD. If the Southeastern Public Service Authority of Virginia were to sell its product to a private company, you would not have this problem, would you?

Mr. CHIRLS. That is correct.

Senator BYRD. You only have it because the U.S. Navy would benefit to the extent that it would use 800,000 less barrels of oil per year and also would not be faced with a big financing program that Admiral Heid says that the Navy will be confronted with if it cannot use this facility. Is that correct?

Mr. CHIRLS. That is correct. your bill actually focuses on two impediments that exist under current Treasury regulations to the financing of this facility.

One is, as you have mentioned, the problem that the steam and electricity will be sold to the Navy. The Internal Revenue Service has issued rulings by which they have said that bonds issued by a municipality will not be treated as tax exempt if the source of revenue for the payment of the bonds is derived from payments by the Federal Government.

That may be appropriate in some circumstances, such as where bonds are used to finance an office building to be rented to the Federal Government on a long-term basis, but that is inappropriate in this situation where the project is primarily designed to benefit a municipality and the bond holders are not looking to the credit or the Federal Government to pay the debt, but rather, it is the overall project and many of the risks involved in the project that deal with the security for the bonds.

Senator BYRD. I think that the Treasury and Secretary Lubick came to see me and talk it over with me. I think the Treasury's concern was about a possible precedent which it would create. It seems to me that the Treasury's concern could be worked out within the framework of the legislation.

I think it is fair to say also that the Treasury sees merit in the overall proposal but does, as I say, have a concern about the precedent.

Appropriate Treasury officials will be meeting with some of you on Friday and I am hopeful as a result of this that something can be worked out to the satisfaction of both parties.

Frankly, Treasury's opposition does not seem very logical to me. I was in a community in Virginia just recently where a very fine, well-managed rapidly growing savings and loan company is putting up a building with tax-exempt bonds. That is permitted under the law, and I suppose that they have an obligation to take advantage of it.

If that can be done, and doctors can put up office buildings with tax-exempt bonds, certainly it seems to me that, in the case of seven municipalities in the State of Virginia joining together to utilize urban waste and obviate the need for fossil fuel, certainly the Congress would not want to discourage such a project while encouraging these others.

But we will just have to see. I think that this is a fair proposal. I think it is a proposal if it were to be utilized extensively could mean a great deal in the way of reducing our energy needs on imported oil.

Does anybody else on this panel want to make a comment?

Mr. ALDRICH. For the Northeast—Rhode Island, in particular, there is not a source of petroleum fuels that we have in the rest of the country. The direction to be served by this bill in utilizing municipal waste, particularly in Rhode Island where they have a State agency developing such a program, similar to what we are trying to do in Virginia, is very important and garbage is a source of fuel in the Northeast. It is extremely important.

I think you will see a lot of support by fellow Senators from all over the country, but particularly in our section.

Senator CHAFEE. I find that a very powerful statement.

Senator BYRD. That thought went through my mind when I heard Rhode Island mentioned.

Ms. KONHEIM. Mr. Chairman, may I ask that my written statement be included in the record, and I would also like to call to the attention of Senator Chafee that modifications to the New England Power Co., who we have been working with, would not qualify under the legislation as currently introduced since it requires that the processing facility be located contiguously to the power user. The New England Power Co. is very interested, and has contracted with us, to use fuel that is produced by waste, not located on a site next to their own powerplant.

Therefore, we ask that the committee give full attention to making the amendments I suggested so that you are not discriminating against half of resource recovery the technology refuse derived fuel systems, which is available to get energy out of refuse.

Senator BYRD. Thank you.

Senator Warner and I will work closely with Senator Chafee and see what can be developed.

Senator Chafee?

Senator CHAFEE. Thank you very much. I was not conscious of that. I appreciate what Ms. Konheim said.

Thank you very much, Mr. Chairman.

Senator BYRD. Senator Dole?

Senator DOLE. I have no questions.

Senator BYRD. Well, I think that all of you have made a very good case for this legislation. I hope that the meeting that you will have Friday with the Treasury Department will resolve what slight difficulties there seem to be.

Thank you.

[The prepared statements of the preceding panel follow:]

TESTIMONY

OF

JOHN P MILLHONE

DIRECTOR, OFFICE OF BUILDINGS AND COMMUNITY SYSTEMS

Ladies and Gentlemen of the Senate Committee on Finance. Thank you for the opportuni / to speak before this hearing dealing with municipal solid waste.

The Department of Energy views municipal solid waste as a valuable energy source. By 1985, the Nation will be discarding 200 million tons of waste per year. This represents a total potential energy resource of two (2) quads. If all the energy intensive materials such as steel, aluminum, glass and certain paper fiber were recovered and recycled we would conserve an additional one (1) quad of energy. However, we can not expect to recover all of the available municipal waste. With current technology the national potential is estimated at 55% of the total. As we develop smaller scale systems, and systems combining other wastes such as those from agriculture and forestry operations that potential is expected to increase to 90% of the available municipal waste.

Presently DOE is supporting research and development to increase the options for the recovery of energy from waste, to solve specific technical problems, and to identify and develop generic solutions to institutional or non technical problems. In addition, DOE and EPA have entered into a Memorandum of Understanding that provides for EPA support to municipalities for feasibility studies and procurement planning by funding provided as part of the President's Urban Policy Initiatives.

The President has recently sent to Congress a number of energy proposals including the Energy Mobilization Board and the Energy Security Trust Fund. The Energy Security Trust Fund would also most significantly, have authority to provide incentives for converting wastes to useful energy forms.

The Administration believes these to be appropriate measures to support efforts to reduce our dependence upon foreign oil and to expand our energy resources.

I am pleased to briefly describe for you the DOE program in the recovery of energy from municipal wastes the results of our 1979 efforts, and the projects we intend to pursue in FY 80.

In Fiscal Year 1978, DOE provided support to twenty cities developing potential demonstrations of new technologies. In addition, seven other projects may lead to the demonstration of new technologies. For example, in cooperation with EPA, we are supporting Stanford University to develop an atomospheric fluidized bed fueled by municipal waste to produce steam, using background data and equipment from EPA experiments. Two other projects will add energy recovery boilers to existing incinerators.

DOE issued three competitive procurements during FY 1978 and continued their support in FY 1979. These three Requests for Proposals (RFP's) aimed at:

1. the recovery of energy from sewage sludge,
2. exploring the energy advantage of combining municipal waste and wastewater treatment and,
3. the recovery and use of methane from landfills.

The latter is particularly significant since it converts wastes buried over the last ten years into an energy source capable of producing about one-tenth of a quad of energy while decreasing the explosion hazards associated with landfills. This effort is being continued in FY 1980 to look at the design parameters of recovery.

We are continuing our Pompano Beach project which, converts municipal solid waste to methane. The plant is completed and has been producing methane since August, 1978. There have been no problems with the digestion process to date, although we have had a number of problems with the part of the plant that prepares the incoming waste for use in the process. These have been solved and the plant is now operating at design rate. This effort will continue in Fiscal Year 1980 in order to test digester mixing and to achieve high rate production. In this same area of bioconversion we have an effort to produce ethanol from waste by enzymatic hydrolysis.

There is a strong program in existence in the federal government to recover energy and materials from waste. The Environmental Protection Agency is conducting research into the environmental concerns of energy recovery. Under the President's Urban Initiative they are providing grants to municipalities to conduct feasibility studies and procurement planning that will lead to waste-to-energy plants. In addition, they provide technical assistance teams and frequent seminars for technology transfer. The Department of Energy is conducting research and development activities in the areas of technical and institutional problems associated with energy recovery from wastes.

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The proposed bill, S1514, provides that industrial development bonds issued by tax-exempt State and political subdivision may be used as a means of financing solid waste disposal facilities where steam or electric energy produced at such facilities are sold to and used by the Federal Government.

The bill further provides that tax-exempt industrial development bonds may be used to fund facilities which combine both solid waste disposal and energy production. This means that where the conversion from solid waste to electricity is part of an integrated process the entire facility, including steam boilers and electric generators, may be financed by tax-exempt bonds.

One such plant that the proposed bill would affect is the proposed waste recovery plant at Norfolk, Virginia. We understand that this plant would be a large scale plant that would cogenerate electricity and steam for sale to the Norfolk Navy Yard to provide the principal source of energy for that facility. If the input for this proposed facility were 1500 tons per day, it could displace an estimated 2000 barrels of oil per day.

Because the proposed bill deals primarily with revisions to Internal Revenue Code, we defer to Treasury Department for specific comment on the bill.

Thank you for this opportunity to testify and I will be pleased to answer any questions.

SUMMARY
of testimony of
SOUTHEASTERN PUBLIC SERVICE AUTHORITY
OF VIRGINIA

regarding

S. 1514

September 17, 1979

The Southeastern Public Service Authority of Virginia urges approval of S. 1514.

S. 1514 would amend the Internal Revenue Code to permit tax-exempt revenue bond financing by states and their political subdivisions to finance the construction of municipal solid waste disposal facilities where steam and electricity is produced and sold to the Federal government.

S. 1514 further permits the financing with tax-exempt revenue bonds of electrical generating equipment which uses steam recovered from the municipal solid waste disposal process.

Approval of S. 1514 by the Congress is necessary for the implementation of a municipal solid waste to energy program now being developed jointly by the Southeastern Public Service Authority of Virginia and the United States Navy.

STATEMENT
ON BEHALF OF
SOUTHEASTERN PUBLIC SERVICE AUTHORITY
OF VIRGINIA

by

Patrick L. Standing, Chairman
and
Mayor of Virginia Beach, Virginia

Robert H. Aldrich, Senior Vice President
Paine, Webber, Jackson & Curtis Incorporated

and

Richard Chirls, Esq.
Brown, Wood, Ivey, Mitchell & Petty

I am Patrick Standing and I appear as Chairman of the Southeastern Public Service Authority of Virginia and as Mayor of the City of Virginia Beach, Virginia. With me today are Robert H. Aldrich, Senior Vice President of Paine, Webber, Jackson & Curtis, Incorporated, New York and Richard Chirls, Esq., of Brown, Wood, Ivey, Mitchell & Petty, New York.

INTRODUCTION

The Public Service Authority, a political subdivision of the State of Virginia, is made up of eight communities including the Cities of Chesapeake, Franklin, Norfolk, Portsmouth, Suffolk, Virginia Beach and the Counties of Isle of Wight and Southampton. These communities have a combined population of approximately 800,000 people.

In 1974 municipal solid waste disposal was identified as one of the major problems facing the local governments of Southeastern Virginia. During the course of the many studies designed to find solutions to this problem, the energy production problem at the Norfolk Naval Shipyard in Portsmouth, Virginia, was identified. The Shipyard is in the position

of having to develop a new source of steam and electricity to replace its worn out power plant. These two problems lend themselves to joint solution by using the solid waste generated in the communities as a fuel to produce steam and electricity for the Shipyard. This project as conceived is an outstanding example of the potential for intergovernmental cooperation that could serve as a model in the future for similar municipal solid waste to energy efforts between local governments and nearby Federal installations.

During the past several years the Authority and the U. S. Navy have been working together to develop the municipal solid waste to energy program in a manner that will serve the mutual benefit of both. The engineering and other costs have been funded by the participating local governments who have expended more than $2,200,000 thus far. The funds were committed after receiving assurances from local representatives of the U. S. Navy of their support for the program.

The Authority has put together a team of nationally recognized architects, engineers, investment bankers and legal advisors to undertake the planning and design for the project. At this time, both firm capital and life cycle cost estimates for the project have been completed. A significant portion of the design for the project has been completed. In addition, the Authority has applied for and received required air emissions permits from the Environmental Protection Agency, prepared and summitted the Environmental Impact Assessment, and has been developing an energy purchase contract with the U. S. Navy.

Landfills for solid waste disposal in six of the seven communities served by the Authority are nearing the end of their useful lives. This fact, plus the energy producing problems at the Shipyard, led to the joint program with the U.S. Navy to utilize the solid waste as a source of fuel rather than continuing to bury it in the ground. We feel that this decision is in the best long term interest of Southeastern Virginia and the Nation.

The benefits to be derived in Southeastern Virginia and the Nation from the utilization of municipal solid waste as a source of fuel to produce energy for the Shipyard is summarized as follows:

1. It will greatly reduce the volume of municipal solid waste to be landfilled with a corresponding reduction in the potential for groundwater pollution. The character of the non-energy producing solid waste remaining to be landfilled is of a nonputrescible character that will not produce odors or other environmental problems.
2. It is in keeping with the Nation's objective of reducing reliance on fossil fuels as a source of energy. At present, approximately 800,000 barrels of oil are used annually to produce the steam and electricity consumed at the Shipyard. In addition, the refuse derived fuel produced from the municipal solid waste generated in

Southeastern Virginia will have heating value over the thirty year life of the project equivalent to over five million tons of coal, over 118 billion cubic feet of natural gas or just under 24 million barrels of crude oil.

3. It will result in improvements in air quality in the area in that the obsolete, oil fired power plant presently serving the Shipyard and two incinerators currently burning solid waste will be shut down.

4. It will result in the recovery of over one million tons of ferrous metals and nearly 75,000 tons of aluminum over the project's 30-year life.

5. It will result in substantial savings to the U.S. Navy. The power plant currently serving the Shipyard is worn out and must be replaced. As its alternative to obtaining its steam and electricity from the Authority, the U.S. Navy is considering constructing a coal gasification plant at an estimated capital cost of $99 million. If the municipal solid waste fired facility is not constructed, the Navy plans to seek an appropriation from the Congress to construct such a facility. The municipal solid waste fired power plant will have approximately twice as much firm electrical output as will the Navy's alternative. A comparison of the projected

life cycle cost of the municipal solid waste fired facility to the coal gasification plant indicates that the Federal government will save approximately $400 million in energy procurement cost over the project's thirty year life.

6. The municipal solid waste fired facility will produce annually approximately 154 million killowatt hours of electricity, enough to serve about 14,000 homes. It will also produce annually for sale to the Shipyard approximately 1.5 billion pounds of steam.

IMPACT OF S. 1514 ON THE DEVELOPMENT OF RESOURCE RECOVERY

Recovery and recycling of resources from our municipal waste stream has significant local and national benefits:

(1) it reduces the burden on local communities in siting and maintaining landfill sites;

(2) it recycles back into the economy processible raw materials including: iron, aluminum, glass, plastic, paper and non-ferrous metals;

(3) the energy values contained in the organic and cellulosic portions of the waste stream can be recovered in the form of a fuel, steam, synthetic oil or gas, and electricity.

In years past, recycling was limited to the scavenging of valuable materials from the waste stream, primarily high cost metals, rags and recyclable papers. In the last few years due to the combination of rising landfill costs, sites becoming less readily available, and the price of energy increasing disproportionately to the rest of the economy, recycling on a major scale began to receive more attention at the Federal, state and local levels. As a result, we have seen the emergence of a new industry based on the economic recovery and recycling of products and energy from our municipal waste system.

Today there are seven large resource recovery facilities in operation, extracting energy and materials from waste, the total design capacity of these plants being approximately 5,800 tons of municipal waste per day. Four more major facilities with a combined capacity of 6,200 tons per day are in the advanced stage of startup. In addition several small commercial and municipal facilities are in operation, or are in the process of construction.

Resource recovery technology has, with some difficulty, crossed the threshold of technical feasibility and the systems are beginning to be economically competitive with alternative methods of disposal. The systems in place today demonstrate that multiple technologies are available which

can provide effective, reliable and affordable means of recovering useful energy and recycling, with significant energy savings, certain recoverable materials. Simultaneously, landfill disposal can be reduced by ten-fold and the environmental quality of the landfill sites improved.

The potential for resource recovery to make a significant contribution to the Nation's energy goals has been barely tapped. Today's waste to energy capacity represents less than 3% of the potential 220 million barrels of oil equivalent contained in the municipal waste stream. This Bill will provide added incentive to municipalities to convert their waste into useful energy.

Reasons for Slow Development of Resource Recovery Potential

The reasons why resource recovery has not been exploited as an alternative energy resource are complex and diverse. The primary reason is that the short term economic incentive for communities to convert from landfill to resource recovery has not existed. While the trends in energy and material prices, and increasing costs of landfill have all been positive, the local communities have hesitated in undertaking the major program for conversion due to the risk factors associated with combustion processes and the higher initial cost of disposal associated with resource recovery.

Despite this, many municipalities have decided to move forward in this area, only to be thwarted or delayed in their efforts by:

(1) uncertain and costly environmental regulations;

(2) legal constraints in procuring facilities or securing control over the waste stream; and

(3) uncertainties in the mechanisms by which such facilities can be financed.

Clarifying the Financing Mechanism for
Municipal Solid Waste Resource Recovery Facilities

Municipalities have historically financed solid waste management facilities by the issuance of municipal debt, general obligation bonds, revenue bonds or special assessment bonds. Municipal solid waste resource recovery facilities frequently utilize the private sector as the constructor, operator or user of the energy derived from such facilities. As a result municipalities have been essentially limited to the use of revenue bonds as permitted under Section 103(b)(4) of the Internal Revenue Code.

As discussed later, Treasury regulations defining the facilities eligible for tax-exempt financing have been unduly restrictive, and frequently confusing to communities attempting to finance municipal solid waste resource recovery facilities. There is serious concern now that Treasury intends to put further restrictions on the use of this form of financing which is having a serious impact on the continuing development of resource recovery projects throughout the United States. It is time that Congressional intent be better defined so as

to give positive direction to the Department of the Treasury in this specific area of tax-exempt municipal financing.

Several major problems exist in the current interpretation of existing statutes and regulations:

(1) the Treasury Department has set arbitrary and sometimes unrealistic cut off points in the solid waste process stream beyond which tax-exempt financing is not allowed, e.g. facilities producing steam may be financed but financing for the facilities to transport the steam to market or to convert unsaleable steam to saleable electric energy is not allowed;

(2) the Treasury Department, by its regulations, has inadvertently limited the choice of the communities in the selection of the most economical technology for solid waste disposal;

(3) there are several important major projects in the United States where the Federal government is the sole potential customer. Under existing interpretations tax-exempt financing generally cannot be utilized by the municipalities for such projects.

S. 1514 clearly states the objective of Congress to retain the historic rights of municipalities to finance solid waste disposal facilities, and recognizes the changing

technology and institutional aspects of resource recovery. S. 1514 enables local communities and Federal facilities in their area to mutually work together on resource recovery projects.

Cost of S. 1514 to the Federal Treasury

The cost of this Bill to the Federal Treasury has been estimated by the Joint Tax Committee based on the total income tax revenue losses associated with the issuance of tax-exempt debt. Under such a calculation, the estimated losses to the Treasury from this Bill are quite minimal, going from $2 million per year in 1980 to an estimated $81 million per year in the later years. However, for this particular Bill the direct costs to the Federal government are reduced by the economic benefits derived from the savings in fuel costs to Federal facilities and the strengthening of the dollar due to the development of a significant alternative and renewable energy source.

ECONOMIC IMPACT OF S. 1514 ON THE AUTHORITY'S PROJECT

Senator Byrd, as reported in the July 13th Congressional Record-Senate, stated that if the financing of the resource recovery project of the Southeastern Public Service Authority of Virginia cannot be accomplished through the sale of municipal bonds at tax-exempt rates, the project would not be economically

feasible and would fail. The same sentiments were expressed by Congressman Daniel in the July 27th Congressional Record-House. The tax-exempt rate currently projected is 7-1/2% for a 30-year maturity. Should the security for the financing remain as it now appears but the bonds bear interest at taxable rates, the cost of borrowing would be at least 10-1/2%. This adds approximately $140 million to the cost of the project over its projected life, or, $4.65 million per year. The cost per ton to the communities for waste disposal would increase approximately 30% due to the increased interest cost alone. While such an increase could be palatable to a few of the local governments because they now have no viable alternative for the disposal of the community's solid waste, the majority would forego resource recovery in favor of existing landfills. (The environmental hazards of continued use of landfills as historically operated have been well documented.) The U.S. Navy would expect to pay an increase of 10% over its own estimated alternative energy costs in the first year in such a case. This would cause the Shipyard to be non-competitive from a cost view with other shipyards. Either of these cost increases due solely to the increased burden of taxable interest rates in the early years would make the project unacceptable to the Authority, the local communities, and to the expressed needs of the Navy.

During the planning, designing and estimates of this project, an Economic Life Cycle Model has been developed. This computer program has facilitated the projection of costs and required revenues. It shows that the project is economically feasible if financing is available at tax-free rates. The project can meet the Navy's needs for the Shipyard to remain competitive in the early years and provide substantial savings over its life. Those savings, as compared to the Navy's own best estimates of its selected alternative, are over $400 million. This amount represents a lost opportunity should the project fail because the burdensome interest cost in the early years forces cancellation or delay.

LEGAL DISCUSSION OF S. 1514

The use of tax-exempt bonds as a mechanism for providing financial assistance to encourage the maximum development of resource recovery technologies is presently permitted. Typically, municipal solid waste disposal and resource recovery plants have been financed through the issuance of tax-exempt revenue bonds, the payment of which is secured by long-term contracts for the sale of steam or electricity produced at the plant. Section 103(b)(4)(E) of the Internal Revenue Code provides that the interest on bonds used to finance the construction of solid waste disposal facilities will be exempt from Federal income tax. However, the exemption,

as currently interpreted and applied, is of such limited scope that in many instances tax-exempt financing is unavailable.

For example, the Internal Revenue Service has in the past taken the position, in both published and private rulings, that tax-exempt bonds may not be used to finance facilities which are used by or for the benefit of the Federal government where a substantial portion of the debt service for the bonds is derived from revenues paid by the Federal government on account of such use. Accordingly, even though the motivating force for the construction of a solid waste disposal facility is to solve local municipal garbage disposal problems, the Internal Revenue Service will not permit tax-exempt financing where recovered by-products of the solid waste disposal process are used by or for the benefit of the Federal government or where the revenues derived from the sale of such by-products are used to pay a substantial portion of the principal or interest on the bonds.

The limited market for sale of the recovered by-products of solid waste has constituted a substantial impediment to the large-scale development of solid waste disposal and resource recovery facilities. The number of potential users of such by-products who have sufficient incentive to enter into long-term purchase agreements which will provide financial security for a project is small. Therefore, in order to

encourage development of these facilities, increased markets for these by-products must be found.

In several instances an agency of the Federal government has considered the purchase of recovered solid waste by-products. In particular, the Armed Services has indicated an interest in the use of such energy related by-products in connection with several military facilities around the country, in part, as a response to the strong encouragement of Senator Hart's report of the Committee on Armed Services which accompanied the Military Construction Authorization for 1979. However, as a result of the IRS position regarding the taxability of bonds issued to provide Federal facilities, no solid waste disposal and resource recovery facilities have been constructed which contemplate the sale of recovered by-products to the Federal government.

The Bill provides that tax-exempt revenue bonds may be used to provide a solid waste disposal facility where any materials, gas, heat, or energy that is recovered or results from the solid waste disposal process is to be used by, or for the benefit of, an agency or instrumentality of the Federal government or where the bonds are payable from payments made in respect of such use by an agency or instrumentality of the Federal government. The Bill does not, however, permit the broad use of tax-exempt bonds to finance facilities for the benefit of the Federal government. Rather, the Bill

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is limited in its scope to the financing of solid waste disposal facilities--which is an accepted and long-standing use of tax-exempt bonds. In effect, the Bill would permit the use of tax-exempt bonds to finance solid waste disposal facilities regardless of whether a private profit-making corporation or the Federal government uses the materials, steam or electricity produced at the facility or provides for the payment of the bonds.

An additional current impediment to the use of the tax-exempt bonds in connection with solid waste disposal facilities arises as a result of the narrowly circumscribed definition of the facilities which are eligible for such financing. Under present regulations promulgated by the Department of the Treasury, the portion of a facility which qualifies for tax-exempt financing includes the portion relating to the recovery of materials or heat from the disposal process and further processing to put them into the form in which the materials or heat are commercially saleable, but does not include further processing which converts the materials or heat into other products. Consequently, tax-exempt bonds may not be used to finance electric generating equipment which uses steam recovered from the solid waste disposal process. Further, as the technology involved in solid waste disposal has developed, it has become common to design more energy-efficient facilities which will segregate a combustible

fraction of the solid waste. This material is commonly known as refuse derived fuel ("RDF"). As the economic incentives to acquire fossil fuel substitutes have increased, the possibility that RDF will be commercially saleable has emerged. Therefore, under the Treasury's present regulations, to the extent that RDF is regarded as a commercially saleable by-product, tax-exempt financing is available only for the portion of a facility up to the point where the RDF is segregated. It is understood that the Treasury is considering the issuance of additional regulations which would impose further restrictions on the use of tax-exempt financing for a solid waste disposal facility where a commercially saleable by-product is recovered from the solid waste disposal process.

The Treasury's present (and, possibly, future) rules create substantial impediments to the financing of solid waste disposal facilities by municipalities. In each instance a determination must be made as to the point in the process at which a commercially saleable product is created. Due to the ambiguity of the Treasury regulations, an advance ruling from the Internal Revenue Service must be obtained in nearly every case. The cost, in terms of both time and effort, involved in this stage of planning has proved to be a sufficient disincentive in some cases to require plans for solid waste disposal facilities to be abandoned. Another

adverse effect of the Treasury's current position is that it requires either that the RDF, where produced, or the steam be sold as a final product or that any facilities for additional processing of the RDF or steam be financed at higher taxable borrowing rates. In most cases the price at which RDF or steam may be sold will not produce sufficient revenues to permit the project to be financed.. Alternatively, the price that must be charged for steam or electricity, as the final product, will be so high as to not be competitive with other forms of energy.

The end result is that many proposed solid waste disposal projects will not be built, or that the cost of utilizing a system which creates RDF will be avoided by relying on technology which disposes of solid waste material in a less energy-efficient manner.

Accordingly, the Bill provides a definition of qualifying solid waste disposal facilities for purposes of Section 103(b)(4)(E) of the Internal Revenue Code which would remove some of the disincentives to building solid waste disposal and resource recovery plants. This definition provides that a facility for the disposal of solid waste material includes any facility which has the function of recovering material from the solid waste disposal process and any facility operated by or on behalf of a governmental unit in order to

produce gas, heat or energy directly or indirectly from the solid waste disposal process and which is located at the same place as, or adjacent to, a solid waste disposal facility. The Bill is limited to permitting tax-exempt financing for a wholly integrated solid waste disposal and resource recovery facility which is operated by or on behalf of a governmental unit. Accordingly, the benefit of tax-exempt borrowing will only be available to finance facilities which dispose of or process municipal solid waste whether owned or operated by a municipality or by a private entity. However, the use of tax-exempt bonds will not be extended beyond its present scope as interpreted by the Treasury to finance facilities which are for the sole benefit of private industry, such as a bark burner to process the solid waste by-product of a paper mill.

The Southeastern Public Service Authority of Virginia plans to construct a solid waste disposal and resource recovery plant in Portsmouth, Virginia to serve a five-city and two-county area. The facility will be constructed on United States Navy land, and the predominant source of revenues for the payment of principal and interest on the bonds issued to finance the plant will be derived from payments made by the United States Navy for steam and electricity to be supplied to the Norfolk Naval Shipyard by the plant. The project is designed to meet both the require-

ments of the municipalities to dispose of their solid waste in an economically and ecologically sound manner and the Navy's need for low-priced energy. The facility is designed to utilize the most modern proven technology available in order to operate at the greatest efficiency. Accordingly, the disposal process will produce a refuse derived fuel which will, in turn, be utilized to generate steam and electricity for sale to the Navy. The production of steam and electricity and its subsequent sale is necessary for the economic viability of the project. However, under existing Treasury regulations, the cost of the electric generating equipment must be financed at a higher taxable cost of borrowing. Further, unless the Authority can prove to the satisfaction of the IRS that the refuse derived fuel has no commercial market, nearly one-half of the cost of the plant will be financed at taxable rates of interest. The resulting financing costs will, therefore, be so high as to destroy the economic soundness of the project and require the Authority to abandon its plans. The problems confronting the Authority in its proposed project are applicable to several similar projects around the country. The Bill will permit responsibly planned projects to proceed as a result of the financial benefit derived from tax-exempt financing.

In summary, as part of a continuing effort by the Congress to promote the development of means to deal with the nation's growing waste disposal problem and to promote energy-related resource recovery, the present Bill permits the use of the existing tax-exempt bond mechanism to promote such goals.

TESTIMONY OF COMBUSTION EQUIPMENT ASSOCIATES

I am Carolyn S. Konheim, representing Combustion Equipment Associates, Inc. CEA is a New York City-based company with 2600 employees engaged in the design and manufacture of pollution controls, energy and agricultural products. The New York Stock Exchange listed company has assets of over $150 million and annual sales of $163 million.

I am here to testify on S-1514 which would amend the Internal Revenue Code with respect to aspects of solid waste disposal facilities.

CEA designs, builds, owns and operates resource recovery plants which convert refuse from solid municipal waste into a high Btu synthetic fuel, ECO-FUEL[R]II through a proprietary patented process.

ECO-FUEL is sold to electrical utilities as a substitue for oil or coal. It is described in the February 1979 issue of Power Magazine: "The only refuse derived fuel of uniform quality commercially available today, ECO-FUEL II, is manufactured by Combustion Equipment Associates, Inc. ... ECO-FUEL II is a dry free-flowing powder with a high bulk density. Experience at several plants has proved that it is easy to transport, store, and handle with conventional equipment used in the cement and grain industries. Its consistency of particle size, high oxygen content, and uniformly high heating value allows rapid and complete combustion. Several engineers claim the flame pattern, flame stability, and ignition characteristics witnessed during ECO-FUEL combustion are equivalent to, or better than, those observed when burning pulverized coal. In addition, the fuel is flexible: It can be fired as a powder with existing, unmodified pulverized-coal burners, or in briquette form."

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For those reasons, CEA has been able to establish long term puchase contracts with utilities. These include:

United Illuminating Co., Connecticut

Public Service Gas & Electric Co., New Jersey

New England Power Co., Rhode Island

and a half dozen others who have signed either letters of intent or preliminary agreements.

ECO-FUEL will be burned at United Illuminating in Bridgeport, Connecticut next week.

As part of CEA's contracts with the utilities, we construct on-site fuel receiving, storage, and fuel feed facilities. CEA's contract covers any necessary upgrading of air and water pollution controls and ash removal equipment. As with any refuse derived fuel process, these energy conversion facilities are an integral part of our resource recovery system.

While CEA's current projects are not utilizing Industrial Revenue Bonds, this possibility should not be precluded for future financing. The restrictions of S-1514 are, therefore, of concern to us.

As introduced, S-1514 disallows tax exempt status to energy conversion portions of a solid waste disposal system if they are not contiguous to the disposal facility. This is strongly discriminatory against virtually all refuse derived fuel processes in which the refuse processing facility is rarely located next to the fuel user. The flexibility of optimally siting plants according to environmental, traffic flow and other land use needs is their very advantage. While the utilization of existing power plants normally reduces the overall disposal cost to the community, such plant sites rarely have room to accommodate a new processing facility.

Only one category of technology qualifies under the proposed language: incinerators which produce steam which is used for heat and/or electricity. Assigning tax advantages to the vendors of these processes gives them an undue advantage in financing resource recovery plants.

Therefore, we urge deletion on p. 2 line 6 of the words "and which is located at the same place as, or adjacent to, a solid waste disposal facility."

Additionally, S-1514 is restricted to plants which are publicly owned or controlled. In much of this country, waste collection is managed by private concerns. Even in New York City at least 30 % of the waste is collected by private carters. Disposal may be in publicly or privately owned landfills, incinerators or processing plants.

All public policy is directed to encourage private financing of refuse processing facilities. Virtually no capital grant funds are available.

The magnitude of available solid waste and the increasing energy revenues are attracting private developers to assume the risk of financing resource recovery projects without prior contracts with governmental agencies responsible for waste disposal. CEA/OXY has done this in Newark, New Jersey and will do so at two sites in New York City. These projects are able to assure a waste supply by offering disposal at reasonable costs to surrounding communities and private waste haulers. The reasonable cost is aided by structuring the projects to optimize advantages to taxable and tax exempt entities.

Therefore, we urge that S.1514 be modified to delete page 2 line 3 the words "operated by or on behalf of the governmental unit". Failure to do so thwarts private initiative in solving the solid waste problem and increases the pass through of higher financing costs to the public.

CEA commends the Finance Committee for taking steps to encourage turning our pressing solid waste problem into a meaningful source of renewable energy. We feel certain that it was not the intention of the committee to discriminate by technology or to discourage private investment and that recognition of these provisions can be easily corrected.

Senator BYRD. The next panel will discuss three different pieces of legislation.

Mr. Donald P. Quinn of Boston, Mass., will address S. 687.

Mr. Edward I. Geffner, administrative director, Manhattan Bowery Corp., New York, who will address S. 401, Senator Moynihan's proposal, and Dr. Jay P. Sanford, dean, School of Medicine, Uniformed Services University of the Health Sciences, Bethesda, Md., will discuss Senator Mathias' proposed S. 945.

Mr. Quinn?

STATEMENT OF DONALD P. QUINN, BOSTON, MASS.

Mr. QUINN. My name is Donald Quinn. I am an attorney from Boston and I represent several of the defendants in the Indian land claim which has been brought and settled and completed, virtually, in the State of Rhode Island by the Narragansett Indian Tribe.

I want to thank the committee for the opportunity to discuss in 3 minutes our solution to the 190-year history of dealings between the Federal and State governments and the Narragansett Tribe.

Until 1975, it was really not considered that the Narragansett Tribe was a tribe under Federal jurisdiction. However, in 1975, they brought two suits in the Federal district court that basically immobilized the community, the town of Charlestown, R.I.

The defense of that case would have taken several years in litigation. It would have taken many hundreds of thousands of dollars in litigation costs, attorneys fees, and luckily we were able to settle it. We settled it only several weeks before the trial was to commence in 1978.

The settlement required several things to be done, one of which was to meet the requirement of the Trade and Intercourse Act by obtaining an act of Congress blessing and funding the settlement. We were fortunate in having the dedicated Members of the Congress realize our problems and in a very timely fashion, the Rhode Island Indian Claims Settlement Act of 1978 was passed last September, signed by the President on October 2.

Because of the difficulty in dealing with many of the substantive matters in that bill, and the problems of having your committee and other committees in the House sequentially dealing with the revenue aspects of it, certain provisions of the settlement agreement, which were an integral part of the settlement, were left out and agreed to be dealt with this year in amendatory legislation.

Senate 687 amends the Rhode Island Indian Claims Settlement Act, 1978, in one small respect. That respect, sir, is to give section 1033 treatment to the moneys paid to the private defendants who conveyed their land in settlement of a claim.

Section 1033 treatment would allow people to take the moneys that they receive and, instead of having a recognized capital gain, if they do reinvest the money within an applicable period of time into a qualifying reinvestment, then they will have a deferral of capital gains.

If I can answer any questions regarding this, I would be pleased to.

I am submitting a 25-page memorandum that sets forth in detail the tax consequences.

Senator BYRD. Fine. That memorandum will be published in the record.

Thank you, Mr. Quinn.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

First, I would like to thank you very much for bringing this before the subcommittee, scheduling it. We appreciate it, and we also appreciate Senator Packwood and Senator Dole having given us a hand in moving it along.

The situation is this, briefly, Mr. Chairman. We have this problem in which the Narragansett Indians, as Mr. Quinn said, brought suit. It tied up some 3,200 acres of land in the southern part of the State. The titles were all in limbo.

So finally, a deal was worked out where a corporation was set up which was going to be controlled by the Narragansett Indians, and the State transferred 900 acres of land to this corporation from State lands. Private landowners will also convey about 900 acres to the corporation. Congress last year agreed to put up $3.5 million to buy this land.

As an integral part of the settlement, it was agreed that we would seek section 1033 treatment so the landowners would not have to pay capital gains taxes if they reinvested the proceeds from the sale of their property, I think, in 2 years in similar or related property.

This the standard homeowner thing where the tax is deferred. They keep the same basis on the new land. When they sell that, they will pay their capital gains tax. That was a key part of the settlement. While the sale of this private land is technically voluntary, Mr Chairman, we are proposing section 1033 treatment because the circumstances of the sale are more like a condemnation in reality.

I am not suggesting this solution be used as a precedent for settling Indian land claims in other States. I have no qualifications for making that judgment. This is just something that was worked out for this modest situation.

We are also asking that the Indian corporation not be considered a corporation for income tax purposes, except if it does produce some income, unless the Indians use the land to produce income in some way, but otherwise it would be a nontaxable corporation.

I would like, Mr. Chairman, to submit a letter from Senator Pell, and make it a part of the record, if I might.

[The prepared statements of Senators Chafee and Pell follow:]

PREPARED STATEMENT OF SENATOR JOHN H. CHAFEE

Mr. Chairman, I would like to present a brief background on S. 687 which Senator Pell and I introduced earlier this year. The bill is an amendment to the Rhode Island Indian Land Claim Settlement Act of 1978, Public Law 95-395.

In 1975, the Narragansett Indians filed suits in the U.S. District Court against 35 private defendants and the State of Rhode Island seeking to recover about 3,200 acres of land in Charlestown, Rhode Island. The basis of the claim rests on a questionable act of the Rhode Island legislature dating from 1880 which abolished the tribal authority and tribal relations of the Narragansett Tribe of Indians.

While it is by no means clear that the Narragansetts would have won their case in court, it seemed likely that litigation would have gone on for many years, disrupting the economy of the Town of Charlestown and the State of Rhode Island and putting a cloud over the land titles of the private defendants.

For this reason, an agreement was entered into one month prior to the date the case was to have gone to court. The agreement, which required implementating legislation from both the Congress and the State of Rhode Island, established a State Corporation controlled by the Narragansetts. To this corporation was conveyed a large parcel of land owned by the State. For its part, Congress appropriated $3.5 million for the purchase of 900 acres owned by the private defendants. The Secretary of the Interior is to purchase the land on behalf of the Tribe and convey it to the Corporation as well.

The bill we have before us today was an original part of the Rhode Island Indian Land Claim Settlement Act which was drafted in cooperation with the Administration, the Senate Indian Affairs Committee and the House Interior and Insular Affairs Committee. The Treasury Department has no objection to the bill.

The reason this provision was not included when the Settlement Act was passed last year is simply that the press of time at the end of the 95th Congress would not allow it to be sequentially referred to the Finance Committee for approval.

The amendment has two basic thrusts. One is to encourage private landowners to voluntarily sell their property to the State Corporation in order to complete the settlement. This would be done by allowing those landowners who so choose to defer capital gains from the sale by reinvesting in other property. If the sale were done through condemnation or some other technically involuntary proceeding, the landowners would be entitled to such treatment under Section 1033 of the Code. Although the sales of private land made pursuant to the Rhode Island Indian Land Claim Settlement are technically voluntary, in real practical terms, the private landowners have no other choice but to sell. Therefore, my bill seeks special treatment in this limited case.

The other thrust of the amendment is to provide an exemption from taxation for the State Corporation. The settlement lands themselves should not be subject to any form of federal, state or local taxation.

Mr. Chairman, this bill is tailored specifically to the circumstances surrounding the Rhode Island Indian land claim case. While there may be discussion from others who are concerned that this type of settlement is precedential for other Indian claim cases around the country, I would assure my colleagues that there is no such intention on our part as we seek enactment of this amendment.

Mr. Donald Quinn, attorney for the defendants in the R.I. case, is a member of the panel before the Subcommittee and will be able to provide more detail on some aspects of this legislation. Mr. Tom Tureen, attorney for the Narragansett Indians, was not able to be here but will submit a statement for the Record in support of S. 687.

Statement of Senator Claiborne Pell

Mr. Chairman, I am pleased to have this opportunity to testify in support of S. 687, a bill to amend the Rhode Island Indian Claim Settlement Act. The bill before you this morning will complete implementation of the orignial settlement agreement by providing for deferral of capital gains taxation for privately owned settlement land.

The history of the Narragansett land claim in my state is a long one, and I will not take the Committee's time with all the background. Suffice it to say that arriving at an out of court settlement with the consent of Indians, landowners, and state officials was not an easy task. The settlement agreement was the result of months of painstaking negotiations. The provision calling for a deferral of capital gains was a key inducement to the landowners in the case. This provision was, and is, supported by all parties to the land claim, and was deleted from the settlement bill which President Carter signed last year only for reasons of time. The settlement package was completed late in the 95th Congress, and because of the delicate balancing of interests involved, had to be confirmed by the Congress as quickly as possible. To streamline the bill, and improve its prospects for passage in the waning months of the 95th Congress, the landowners agreed that the capital gains provision would be deleted. The entire Rhode Island Congressional delegation is now committed to seeing this final provision of the settlement agreement signed into law.

From a policy standpoint, this type of tax treatment makes excellent sense in resolving Indian land claims. The administration has taken a firm position against compensating the landowners for losses as a result of being able to convey their property. The landowners in cases of this sort are innocent bystanders caught in a very difficult situation to get out of, and, at the very least, should not be exposed to capital gains taxation on property they transfer in settlement of the Indian claims.

From a tax standpoint, a deferral of capital gains in this situation is totally consistent with current internal revenue law. § 1033 of the Internal Revenue Code recognizes a deferral of taxes on gains occuring as a result of involuntary conversions. The land conveyed by the landowners in this case was threatened with complete forfeiture by the Indian lawsuit. The transfers of land can hardly be characterized as voluntary.

§ 1033 of the Internal Revenue Code is intended to prevent the inequitable imposition of taxation. I strongly believe that had the framers of Section 1033 ever envisioned that this type of situation would occur, they would have included loss of land as a result of Indian land claims within the scope of that section.

I can personally testify to the many sacrifices made by the landowners who were defendants in the Rhode Island Indian land claim. Without their willing participation in the settlement agreement, we would not be here today—because the claim, would still be grinding through the courts. To reject this bill will surely discourage landowners in other states from participating in future settlement agreements.

The bill before you will complete the federal government's responsibility to the parties to the Rhode Island land claim. The bill's impact on federal revenues will be minimal, and its underlying rationale is strongly supported by federal tax policy.

For these reasons, I urge you to report the bill favorably.

Senator BYRD. Yes; it will be made a part of the record.

Senator CHAFEE. He enthusiastically supports it and has been involved in it from the beginning and urges its passage.

Senator BYRD. Thank you, Senator Chafee.

As I understand it, the Treasury Department does not oppose the bill but the statement by Secretary Lubick says, "We would suggest, however, that the language of the bill exempting moneys to be received by the State corporation from the Federal Government be deleted because it is not needed."

Is there any objection to that?

Senator CHAFEE. There is no objection to that.

Once upon a time, the system was they were going to give the money, the $3.5 million, to the corporation. The corporation would buy the land. Now, the Secretary of the Interior is going to buy the land and turn it over to the corporation, so there is no need for that.

Are you in agreement with that, Mr. Quinn?

Mr. QUINN. Absolutely.

Senator BYRD. Very good.

That appears to have been handled satisfactorily. I see no problem with it.

Thank you, Mr. Quinn.

Mr. QUINN. Thank you very much, Senator Byrd.

Senator BYRD. The next witness is Mr. Edward I. Geffner, administrative director of the Manhattan Bowery Corp., in connection with a bill for the relief of the Manhattan Bowery project.

Senator Moynihan has a statement which I will insert for the record on his behalf at this point.

[The material referred to follows:]

STATEMENT OF SENATOR DANIEL P. MOYNIHAN

Mr. Chairman, today the subcommittee will hear testimony by an organization—the Manhattan Bowery Project—seeking our help. It is somewhat fitting that they do so, for the Manhattan Bowery Project has provided help to so many disaffiliated alcoholics who would otherwise be abandoned to the streets.

The Project has restored and rehabilitated many such persons, preparing them to re-enter society, indeed employing some in its own efforts.

Through an administrative oversight, the Project has erroneously filed and received certain Social Security taxes for certain present and former employees. These

funds were duly, if erroneously, paid to these employees, and the IRS rightfully sought to recover these funds.

The Project has acknowledged its error and repaid its share of these funds to the IRS, but because of the nature of the project and its operations, there is little hope of recovering the moneys paid to these employees, many of whom are recovered alcoholics and earn $10,000 per year—hardly unjust enrichment.

And because the project is almost exclusively governmentally funded, there is no other funding available.

To deny the Project this relief would be to terminate their activities and close the center, relegating many homeless to the streets.

Senator BYRD. Mr. Geffner?

STATEMENT OF EDWARD I. GEFFNER, ADMINISTRATIVE DIRECTOR, MANHATTAN BOWERY CORP., NEW YORK, N.Y.

Mr. GEFFNER. Good morning, Mr. Chairman and members of the Finance Committee. I am Edward Geffner, administrative director, Manhattan Bowery Corp., located at 8 East 3d Street, New York, N.Y. 10003, and I am here to testify about S. 401, a bill introduced by Senator Moynihan for the relief of the Manhattan Bowery Corp.

First, I would like once again to thank Senator Moynihan and the members of his staff for their diligent efforts in drafting and introducing this bill and you and the members of this committee for the opportunity to testify. Congressman Weiss, the principal sponsor of the bill in the House of Representatives and Congresswoman Holtzman and Congressman Rangel, cosponsors, have also been most helpful.

My oral testimony will consist of a summary of a statement I have prepared. The summary and the full statement have been submitted to the committee and I would like now, Mr. Chairman, to request that they be incorporated into the record.

Senator BYRD. Without objection.

Mr. GEFFNER. The Manhattan Bowery Corp. is a not-for-profit corporation which treats skid-row alcoholics in several locations in New York City offering detoxification, outpatient, and residential treatment programs. During the 12 years since it was formed, the corporation has helped thousands of Bowery men, many of whom have recovered, maintained their sobriety, and found employment.

Manhattan Bowery is seeking relief from assessments of FICA taxes, interest, and penalties which stem from the confusion that arose in 1974 concerning the requirement of section 3121(k) of the Code that not-for-profit corporations file waivers of their exemption from FICA tax liability to secure social security coverage for their employees.

Since its inception in 1967, the corporation has withheld FICA taxes from employees' salaries and paid these sums plus the employer's contribution to the Internal Revenue Service. In 1974, the Internal Revenue Service became aware that many not-for-profit organizations were making FICA contributions without the legal authority to do so since they had not filed the required waivers.

Manhattan Bowery was concerned because the Treasury had ruled that employees of organizations that had not filed a waiver would not be covered by the social security laws. After a diligent search of its files, the corporation could not locate the waiver. It wrote to the Internal Revenue Service for advice and was informed that if it wished to secure social security coverage for its employ-

ees, it would have to file a waiver which would be retroactive for a 5-year period. However, at the time a waiver is filed, employees may either elect to participate in the social security system or be exempt from FICA taxes.

Manhattan Bowery filed a waiver in April, 1975, but many employees chose not to participate, and therefore they and the corporation were entitled to a refund of FICA taxes previously paid. The corporation also stopped withholding FICA taxes from the salaries of those who elected tax exemption.

During 1975, the corporation received refund checks totaling $174,918.28. It distributed the employees' share and retained the remainder in a separate bank account to return to its funding agencies. In March of 1977, the corporation received notices of tax due. Upon inquiry, the Service stated that it had determined that the corporation had filed a waiver in 1968 and therefore Manhattan Bowery must pay both the employer's and employees' share of FICA taxes for the period January 1, 1973, through June 30, 1977, plus interest and penalties.

Originally they only claimed moneys from January 1, 1973, through April of 1975. We realized that we had not been withholding from 1975 through 1977 and we notified and informed the Service of that fact and we later received notices of tax due for that period as well.

The corporation paid $75,423.44 of the asserted liability of $160,867.37 plus interest and penalties. It is unable to pay the entire amount. Its income is derived from Government contracts and grants to provide alcoholism services. Counsel for the Government agencies has determined that they are prohibited by law from authorizing the use of funds they provide to satisfy the Internal Revenue Service's claim. Moreover, the Service did not assert its claim until 2 years after the filing of the 1975 waiver and claims for refunds. Many employees had left in the interim and it is largely impossible to collect their share plus the interest and penalties.

The corporation has submitted an offer-in-compromise to the IRS. However, we have been informed by the Service that the process is a lengthy one and that the outcome is uncertain. In addition, since the Service requires that the offer consist of at least the trust fund moneys, the corporation would have to pay over $57,000 if the offer were accepted, substantially more than it would if the bill were enacted. If the bill is enacted the corporation would have to pay an additional $16,032.54.

The Service has filed a lien on the corporation's assets and bank accounts. If it forecloses the liens, the corporation will have to cease operations, thereby stopping services contracted for by the Department of Health, Education, and Welfare and the New York City Department of Mental Health, Mental Retardation and Alcoholism Services. The net result will be to transfer funds from one Government agency to another.

Moreover, the Service is largely responsible for this state of affairs since it had several opportunities to inform Manhattan Bowery that a waiver had been filed, but neglected to examine its records.

The Treasury will not suffer financially if the bill is enacted. The employer's share will be paid and employees who want coverage will have to pay their share, that is, the full amount due for social security coverage. For employees who do not elect coverage, the Government will receive a gratuitous payment from Manhattan Bowery.

Senator BYRD. I might say, the Treasury Department's statement to the committee is this:

> In view of the corporation's equitable basis for relief on the facts, the Treasury Department does not oppose enactment of S. 401. However, certain technical amendments are suggested.

I would suggest that you, or Senator Moynihan's staff get together with the committee counsel and with the Treasury Department and try to come to an agreement on those technical amendments, which I think would not be any great problem.

Mr. GEFFNER. We will do that, sir.

Senator BYRD. Thank you.

Senator Chafee?

Senator CHAFEE. I have no questions. Thank you, Mr. Chairman.

[The prepared statements of the preceding panel follow:]

SHORT SUMMARY OF TESTIMONY OF DONALD P. QUINN
REGARDING S. 687 BEFORE THE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE

MONDAY, SEPTEMBER 17, 1979

I. INTRODUCTION

In 1975, the Narragansett Tribe of Indians commenced two lawsuits in the Federal District Court of Rhode Island seeking recovery of several thousand acres of land from the State of Rhode Island and thirty-five private defendants. A Settlement Agreement was reached in 1978 under which Rhode Island and certain private landowners were to convey their land to a state chartered public corporation controlled by members of the Tribe. On October 2, 1978, the Rhode Island Indian Claims Settlement Act (P.L. 95-395) was enacted, constituting Congressional approval of the Settlement and federal funds of the acquisition. Due to press of time, the Settlement Act did not deal with certain provisions of the Settlement Agreement which called for Internal Revenue Code Section 1033 treatment of capital gains incurred by the private landowners who sold their lands to the public corporation.

Senate 687 has been proposed for two reasons: 1) it implements completion of the Settlement Act as originally intended; and 2) its purpose is wholly consistent with those of Section 1033 which permits the deferral of taxes on gains occurring as a result of involuntary conversions.

II. INDIAN LAND CLAIMS UNDER THE TRADE AND INTERCOURSE ACT

The Federal Government has exclusive jurisdiction over lands of qualifying Indian tribes. A trust relationship similar to that between a guardian and a ward exists between the Federal Government and Indian tribes. This fiduciary relationship requires the Federal Government to take such affirmative steps as may be necessary to fulfill its obligations. The failure of the United States to protect Indian tribes from violations of the Trade and Intercourse Act constitutes a breach of its fiduciary relationship. For these reasons, Indian land claims are, in essence, public rather than private actions brought pursuant to explicit provisions of Federal law and the Constitution.

III. THE NARRAGANSETT CASE

The claim of the Narragansett Tribe is derived from an 1880 Act of the State of Rhode Island which purported to abolish the Narragansett Tribe. From 1880 to 1975,

state and federal officials consistently held that the state action was proper. The Narragansett suit questioned the propriety of the legislative act. Absent the Settlement Agreement, the litigation would have continued for many years with the titles of all the defendants and other nondefendants in the general area being made unmarketable pending the outcome of the suit.

IV. THE SETTLEMENT

Notwithstanding the concept of the Settlement Agreement holding that no private defendant should be forced to sell his land involuntarily to the public corporation, as a practical matter, most if not all of the sales are conveyances, which would not have occurred absent the lawsuit which was brought to enforce the Tribe's Federal right. As a result of the conveyances by the State of Rhode Island and the private defendants, the entire State of Rhode Island was freed from the threat of economic hardship caused by both actual and potential Indian land claims.

V. DEFERRAL OF THE RECOGNITION OF GAINS IS CONSISTENT WITH SECTION 1033 POLICY

For a conveyance to qualify as an involuntary conversion under Section 1033, three criteria must be met:

1) Governmental compulsion
2) Threat of condemnation
3) Condemnation for a public purpose

VI. CONCLUSION

The private defendants have an equitable and legal right to §1033 treatment. Their land was threatened by a semi-sovereign Indian tribe and, potentially the United States of America, in its trustee capacity toward the Narragansetts. The land was conveyed under the threat of complete forfeiture to a public instrumentality. The agreement of the private defendants to sell their land served as a direct public purpose. The acquisition of the land was financed by the Federal Government, a tacit acknowledgement that the landowners had a right to compensation.

In addition, a commitment was made by the Administration during the negotiation of the Agreement to the landowners who participated in the settlement that they would receive §1033 treatment.

THE APPLICABILITY OF THE INTERNAL REVENUE CODE SECTION 1033 TO THE NARRAGANSETT INDIAN CLAIM SETTLEMENT ACT

MEMORANDUM IN SUPPORT OF TESTIMONY OF DONALD P. QUINN BEFORE THE SENATE FINANCE COMMITTEE REGARDING SENATE 687

September 17, 1979

TO: THE SENATE FINANCE COMMITTEE

FROM: DONALD P. QUINN, ESQ., GOODWIN, PROCTER & HOAR, 28 STATE STREET, BOSTON, MASSACHUSETTS, CO-COUNSEL TO THE PRIVATE DEFENDANTS IN THE CASE OF NARRAGANSETT TRIBE OF INDIANS V. SOUTHERN RHODE ISLAND LAND DEVELOPMENT COMPANY, ET AL.

RE: PROPOSED AMENDMENT TO RHODE ISLAND INDIAN CLAIMS SETTLEMENT ACT (P. L. 95-395)--S. 687; H. 2993

I. INTRODUCTION

On January 8, 1975, the Narragansett Tribe of Indians initiated two lawsuits in the United States District Court for the District of Rhode Island against the State of Rhode Island and thirty-five private defendants. Narragansett Tribe of Indians v. Rhode Island Director of Environmental Management, C.A. No. 75-0005 (D.R.I.) and Narragansett Tribe of Indians v. Southern Rhode Island Land Development Co., et al., C.A. No. 75-0006 (D.R.I.). Approximately one month before these actions were scheduled for trial, the parties to the litigation executed a Joint Memorandum of Understanding Concerning Settlement of the Rhode Island Indian Land Claims ("Agreement"), February 28, 1978, attached hereto as Exhibit A. Under the terms of the Agreement, the State of Rhode Island and certain private landowners were to convey their land to a proposed state-chartered, public corporation ("Narragansett Corporation") controlled by members of the alleged plaintiff tribe.

The Agreement represented the first out-of-court settlement of Indian land claims brought pursuant to the Trade and Intercourse Act of 1790[1] (25 U.S.C. § 177). On October 2, 1978, President Carter signed into law the "Rhode Island Indian Claims Settlement Act" (P.L. 95-395), attached hereto as Exhibit C, as the first step toward implementing the Agreement. Three Million Five Hundred Thousand Dollars was appropriated by the Federal Government to finance the acquisition of the privately held land involved. On May 10, 1979, Governor Garrahy signed the state implementing legislation known as the "Narragansett Indian Land Management Act", attached hereto as Exhibit D.

The Federal and State implementing legislation incorporated most of the terms of the Agreement. However, section 4 of the Agreement which states "[t]he parties to the Lawsuits will support efforts to obtain deferral of both state and federal income taxes resulting from the conveyance of privately held portions of the Settlement Lands" was deleted "in order not to delay enactment of the settlement legislation since inclusion would have involved sequential referral to the Ways and Means Committee." House Report No. 95-1453, "Summary of Major Provisions", § 5 at 11; see also, Senate Report No. 95-972 at 10, attached hereto as Exhibits E and F. Because § 4 of the Agreement

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1 As of this writing, approximately 19 similar claims covering eight states are, or in the near future may, be in litigation. See, letter of Donald P. Quinn to Don L. Ricketts, Joint Committee on Taxation, March 29, 1979, attached hereto as Exhibit B.

was supported by all the parties to the litigation, by the Administration and by those congressional committees having jurisdiction over Indian affairs, it was agreed that legislation implementing this provision of the Agreement would be resubmitted in this session of the Congress. See, S.687 and H.2993, attached hereto as Exhibit G.

The legislation provides for the deferral of recognition of capital gains resulting from the conveyance of the land of the private defendants to the Narragansett Corporation. We are also proposing an amendment to these bills that the time period within which the seller must reinvest begins to run from the effective date of the act.

It is our belief that the Senate Finance Committee should look favorably upon this legislation not only because it was an integral and important part of the Agreement, but because its purpose is wholly consistent with goals and purposes established by I.R.C. §1033 which permits the deferral of taxes on gains occurring as a result of involuntary conversions. Although a strong case could be made to justify the deferral of recognition of such gains even in the absence of this legislation, we believe that a legislative resolution of this issue is preferable in that it would eliminate uncertainty with respect to the availability of §1033 treatment. To support this position, it is necessary not only to examine the scope and intent of §1033, but the law governing Indian land claims in general and the facts of the Narragansett case in particular.

II. INDIAN LAND CLAIMS UNDER THE TRADE AND INTERCOURSE ACT

In 1790, Congress enacted the Trade and Intercourse Act (25 U.S.C. § 177) which specifically provided that:

> "No purchase, grant, lease, or other conveyance of land, or of any title or claim thereto, from any Indian nation or tribe of Indians, shall be of any validity in law or equity, unless the same be made by treaty or convention entered into pursuant to the Constitution."

While the entire scope and parameters of this provision have not as yet been subject to full judicial determination, the court in Narragansett Tribe of Indians v. Southern R.I. Land Development Co., 418 F. Supp. 798, 803 (D.R.I., 1976) indicated that to establish a prima facie case under the Trade and Intercourse Act, a plaintiff must show that:

> "1) it is or represents an Indian 'Tribe' within the meaning of the Act;
>
> 2) the parcels of land at issue herein are covered by the Act as tribal land;
>
> 3) the United States has never consented to the alienation of the tribal land;
>
> 4) the trust relationship between the United States and the tribe, which is established by coverage of the Act, has never been terminated or abandoned."

Land transfers found to be in violation of the Trade and Intercourse Act are void. Ewert v. Bluejacket, 259 U.S. 129 (1922). Traditional defenses such as laches, adverse possession, statute of limitations and estoppel by sale appear not to be available to defendants in actions brought by Indian tribes. Narranqansett, supra, at 804-805; Board of Commissioners v. United States, 308 U.S. 343, 350-351 (1939). The Supremacy Clause of the Constitution mandates that the extinguishment of

Indian title is a matter of federal, rather than state, law. United States v. Holliday, 70 U.S. (3 Wall) 407, 419-420 (1865); Oneida Indian Nation v. County of Oneida, 414 U.S. 661, 670 (1974).

Article I, § 8 of the Constitution, which provides that Congress shall have the power "[t]o regulate commerce . . . with the Indian tribes", vests exclusive jurisdiction over Indian affairs with the Federal Government.[2] Oneida Indian Nation v. County of Oneida, supra at 667; Pierce v. United States, 255 U.S. 373, 391-92 (1920); United States v. Sandoval, 107 U.S. 28, 38 (1913); Cherokee Nation v. Georgia, 30 U.S. (5 Pet.) 1, 18-19 (1830). The Trade and Intercourse Act which was enacted to implement this exclusive federal jurisdiction over Indian affairs was premised on the notion that Indian tribes or nations were "distinct political communities, within which their authority is exclusive, and having a right to all the lands within those boundaries, which is not only acknowledged, but guaranteed by the United States." Worcester v. Georgia, 31 U.S. (6 Pet.) 515,

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2 In United States v. Lariviere, 93 U.S. 846, 847 (1876), the Supreme Court commented on the direct relationship between exclusive federal jurisdiction over Indian tribes and the semi-sovereign status of such tribes when it stated that "[a]s long as the Indians remain a distinct people, with existing tribal organizations, . . . Congress has the power to say with whom, and on what terms they shall deal, . . ."

557 (1832) (emphasis added);[3] United States v. Sante Fe Pacific R.R. Co., 314 U.S. 339, 348 (1941). According to Chief Justice Marshall, the Trade and Intercourse Act "avowedly contemplates the preservation of the Indian nations as an object sought by the United States" and provides that all relations with such tribes shall be within the exclusive province of the United States. Worcester v. Georgia, supra.

The responsibility of the United States toward Indian tribes or nations was more fully discussed in Joint Trib. Coun. of Passamaquoddy Tribe v. Morton, 528 F.2d 370 (1st Cir. 1975). According to the First Circuit, a "trust relationship" similar to that between a guardian and a ward exists between the Federal Government and Indian tribes. 528 F.2d at 375; see also Cherokee Nation v. Georgia, supra. The Trade and Intercourse Act forms the statutory basis of this trust relationship by establishing that "the policy of the United States is to protect Indian title; . . ." 528 F.2d at 376. There is no requirement that a

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3 To constitute a tribe, a certain degree of independent political authority is required. U.S. Dept. of Interior, Federal Indian Law 461 (1958). Indeed, the term "Tribe", as used in the Trade and Intercourse Act, has been defined by the Supreme Court as:

> "a body of Indians of the same or similar race, united in a community under one leadership, and inhabiting a particular though sometimes ill-defined territory." United States v. Candelaria, 271 U.S. 432, 441-442 (1926) (quoting Montoya v. United States, 180 U.S. 261, 266 (1901).

tribe must be specifically recognized by the Federal Government to come within the provisions of the Trade and Intercourse Act. 528 F.2d at 377. As the First Circuit stated in Passamaquoddy, supra at 379

> "That the Nonintercourse Act imposes upon the federal government a fiduciary's role with respect to the protection of the lands of a tribe covered by the Act seems to us beyond question, both from the history, wording and structure of the Act. . . . The purpose of the Act has been held to acknowledge and guarantee the Indian tribes' right of occupancy, United States v. Santa Fe Pacific R.R. Co., 314 U.S. at 348, 62 S. Ct. 248, and clearly there can be no meaningful guarantee without a corresponding duty to investigate and take such action as may be warranted in the circumstances." (emphasis added).4/

This fiduciary relationship requires the Federal Government to take such affirmative steps as may be necessary to fulfill its obligations. 528 F.2d at 379. These obligations cannot be ignored. Rockbridge v. Lincoln, 449 F.2d 567, 573 (9th Cir. 1971). As the Court of Claims stated in Seneca Nation of Indians v. United States, 173 Ct. Cl. 917, 923 (1965):

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4 Pursuant to the First Circuit's decision in Passamaquoddy establishing a trust relationship between the federal government and Indian tribes under the Trade and Intercourse Act, the United States has indicated its intention to seek recovery of approximately 5-6 million acres in Maine on behalf of the Passamaquoddy and Penobscot Tribes unless a settlement is reached. See, Litigation Reports, United States Department of the Interior re: United States v. Maine, Civil No. 1966 N.D. and United States v. Maine, Civil No. 1969 N.D., Jan. 10, 1977, attached hereto as Exhibit H.

> "The requirement has always been for federal consent and participation in any disposition of Indian real property. From the beginning, this legislation has been interpreted as giving the Federal Government a supervisory role over conveyances by Indians to others, . . . This responsibility was not merely to be present at the negotiations or to prevent actual fraud, deception or duress alone; improvidence, unfairness, the receipt of an unconscionable consideration would likewise be of federal concern... The concept is obviously one of full fiduciary responsibility, not solely of traditional marketplace morals. When the Federal Government undertakes an obligation of trust toward an Indian tribe or group, as it has in the Intercourse Act, the obligation is 'of the highest responsibility and trust,' not that of 'a mere contracting party' or better business bureau."

The fiduciary relationship between Indian tribes and the United States obligates the Federal Government to do whatever is necessary to protect Indian land which has been conveyed in violation of the Trade and Intercourse Act. The failure of the United States to protect Indian tribes from violations of the Trade and Intercourse Act constitutes a breach of the fiduciary relationship, United States v. Oneida Nation of New York, 477 F.2d 939, 944 (Ct. Cl 1973), which imposes "a distinctive obligation upon the Government" which should "be judged with most exacting fiduciary standards." Passamaquoddy v. Morton. 388 F. Supp. 662-663 (D. Maine, 1975).

Not only are Indian tribes unique, semi-sovereign entities but they are considered "wards" of the United States on whose

behalf the Federal Government must exercise affirmative responsibilities. For these reasons, Indian land claims are, in essence, public rather than private actions brought pursuant to explicit provisions of federal law and the Constitution. It is in this context that the Narragansett claim must be viewed.

III. STATEMENT OF THE NARRAGANSETTS' CASE

On January 8, 1975, the Narragansett Tribe of Indians brought suit in the federal district court for the district of Rhode Island seeking to recover approximately 3,200 acres of land in Charlestown, Rhode Island. In the First Amended Complaint ("Complaint") filed on June 24, 1975, attached hereto as Exhibit I, the Narragansetts alleged that the Trade and Intercourse Act discussed in Section II herein, "established and confirmed the Tribe's right of possession to all of the land which is the subject matter of this action." (Complaint, ¶ 11). The Narragansetts' right of possession to the subject land ceased in 1880 when the State of Rhode Island adopted "An Act to abolish the tribal authority and tribal relations of the Narragansett Tribe of Indians", attached hereto as Exhibit J. (Chapter 800, Rhode Island Public Laws, 1880).

It was this act of the Rhode Island legislature which the Narragansetts contended unlawfully resulted in the alienation of their tribal lands in 1880 and which formed the basis of their

action in federal court. (Complaint, ¶¶ 12-17). By way of relief, the Narragansetts asked the Court to declare the defendants' possession of the subject land in violation of the Trade and Intercourse Act (25 U.S.C. § 177) and to "[d]ecree, declare and adjudge that the plaintiff has the right of possession to the land. . . ." (Complaint, ¶ 18, Prayer 1).

The propriety of the Rhode Island General Assembly's termination of the Narragansett Tribe in 1880 was the subject of a lengthy opinion rendered by the Rhode Island Supreme Court in 1898. See Opinion of the Justices of the Supreme Court, 20 R.I. 713 (1898). In particular, the Court sought to determine whether Article I, § 8 of the United States Constitution precluded Rhode Island from exercising direct jurisdiction over the Narragansetts. 20 R.I. at 771. The Rhode Island Supreme Court concluded that although Article I, § 8 gives the federal government exclusive power to regulate commerce with Indian tribes, "the political officers of the United States have never, so far as we can ascertain, recognized the existence of such a tribe as the Narragansetts, hence they are not a tribe, commerce with which by that clause Congress in empowered to regulate."[5] 20 R.I. at 780.

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5 This holding by the Rhode Island Supreme Court was perfectly consistent with existing U.S. Supreme Court decisions on the Trade and Intercourse Act, at the time. For example, in Justice McLean's concurring opinion in Worcester v. Georgia, supra at 580, he stated that:

Until the 1975 action brought by the Narragansetts in the federal court, the legality of the 1880 action of the Rhode Island General Assembly was never seriously questioned. In 1900, a subcommittee of the Committee on Indian Affairs of the United States Senate held hearings "in relation to Certain Claims of the . . . Narragansett . . . Indians." These hearings were intended "to inquire into the legal and political status of the various tribes or claims of Indians", including the Narragansetts. At this time, the Narragansetts specifically asked the Senate "[t]o test the question whether they as a tribe are entitled to the lands which originally belonged to them."

Although c. 800 of the Acts of 1880 was specifically brought to the attention of members of the subcommittee, the Senate never took any action to redress the alleged grievances of the

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5 (continued)

> "In some of the old states, Massachusetts, Connecticut, _Rhode Island_, and others, where small remnants of _tribes remain_, surrounded by white population, and who, by their reduced numbers, had lost the power of self government, the laws of the State have been extended over them, for the protection of their persons and properties." (emphasis added).

Similarly, in the congressional debates over the Indian Removal Policy initiated by President Jackson in 1830, one congressman remarked that ". . . I pass over the laws of . . . Rhode Island . . . in which jurisdiction and sovereignty over the Indians in . . . [its] limits are asserted, as well before the revolution as after it. . ." _Abridgement of the Debate of Congress_, May 1830.

Narragansetts. Indeed, on April 4, 1901, the Department of the Interior stated that "[t]he affairs of the Narragansetts are not under federal control and this office would have no jurisdiction of any claim they might have against said State." Assistant Commissioner, Office of Indian Affairs to James Arnold, April 4, 1901, attached hereto as Exhibit K.

Over the years, the Federal Government consistently held to its position that the Narragansetts were subject to state, rather than federal, jurisdiction. According to the Department of the Interior:

> "The Narragansett Indians have never been under the jurisdiction of the Federal Government and Congress has never provided any authority for the various departments to exercise the jurisdiction which is necessary to manage their affairs. They are under the jurisdiction of different states of New England."

E.B. Meritt, Department of the Interior to Daniel Sekater, June 29, 1927, attached hereto as Exhibit L. See also additional correspondence from the Department of the Interior relative to the Narragansett Indians, attached hereto as Exhibit M.

For almost 100 years, it was assumed that the conveyances authorized by c. 800 of the Acts of 1880 were legal and proper. The defendants in the federal court action brought by the Narragansetts reasonably relied upon earlier determinations by both the State and Federal governments that they had good title to the subject land. It was the defendants' position that had the lawsuits gone to trial, their title to the land would have been upheld. Yet, recent court decisions such as in Passamaquoddy

and Oneida[6] raised the distinct possibility that the United States had failed to fulfill its trust responsibilities toward the Narragansetts in 1880. It was the realization that the defendants risked losing all their land, along with the staggering costs of defending the lawsuits, which ultimately prompted the Settlement Agreement.

IV. THE SETTLEMENT

The Agreement reached among the parties to the Narragansett litigation contained nineteen provisions, all of which were considered "as inseparable, dependent requirements and which are all conditioned upon requisite, favorable and timely action by the appropriate executive and legislative branches of the governments of the State of Rhode Island and the United States of America." Although the United States was not a party to the lawsuits, the Rhode Island congressional delegation and the Administration were kept constantly apprised of the negotiations which led to the settlement. Senate Report, supra at 9.

Under the terms of the Agreement, the Narragansett Corporation was to be created to hold and manage the settlement lands acquired from both the State of Rhode Island and the private

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6 In Oneida, supra at 670, the Supreme Court cast doubt on the widely-held notion that the Trade and Intercourse Act did not apply to states such as Rhode Island by stating that "[t]he rudimentary propositions that Indian title is a matter of federal law and can be extinguished only with federal consent apply in all of the States, including the original 13." See, Worcester v. Georgia, contra at 580.

defendants (Agreement, ¶ 1). Although the settlement lands were to remain subject to the criminal and civil jurisdiction of the State, these lands were to be exempt from local taxation (Agreement, ¶¶ 9, 13). Also, the Narragansett Corporation was to have the right to establish its own regulations concerning hunting and fishing (Agreement, ¶ 11). Development of the settlement lands was to be guided by a land use plan mutually acceptable to the Narragansett Corporation and Charlestown Town Council, with the overwhelming majority of land perpetually committed to conservation purposes (Agreement, ¶¶ 12, 14).

Although the Agreement states that "[n]o private landowner shall be required to convey any land . . . without his or her consent," to the Narragansett Corporation, the signing of the Agreement was contingent upon the prior agreement of certain defendants to convey their land (Agreement, ¶ 3). The acquisition of these private lands was to be financed by a $3.5 million federal appropriation (Agreement, ¶ 5). The State of Rhode Island also contributed land valued at $2.7 million to the Narragansett Corporation (Agreement, ¶ 2; Senate Report, supra at 8).

Because Indian land claims can be extinguished only with the consent of Congress, the parties to the litigation were required to seek implementing federal legislation. The Rhode Island Indian Claims Settlement Act (P.L. 95-395), which implemented portions of the settlement was "predicated, first, upon the finding and conclusion of the Administration that the

Narragansetts have presented a credible claim to the lands involved such that a legislative settlement is justified." Senate Report, supra at 7; letter from Leo Krulitz, Solicitor, Department of the Interior, to Senator James Abourezk, Chairman, Senate Select Committee on Indian Affairs, June 28, 1978, attached hereto as Exhibit N. In addition to the "credibility" of the Narragansetts' claim, the legislation also recognized that "the pendency of these lawsuits has resulted in severe economic hardships for the residents of the Town of Charlestown by clouding the titles to much of the land in the town, including lands not involved in the lawsuits; . . ." (P.L. 95-395, § 2(b)) (emphasis added).

In exchange for Congressional approval of all prior transfers and the extinguishment of all claims of aboriginal title, the Narragansett Corporation received a $3.5 million federal appropriation to purchase lands from the private defendants which would be held in trust for the benefit of the Narranganset Indians.[7] (P.L. 95-395, §§ 4, 6). Extinguishment of the Narragansett

7 In Mashpee Tribe v. New Seabury Corp., et al., Civil Action No. 76-3190-S (D. Mass.) the private defendants brought a third party action against the United States alleging that the failure of the United States to fulfill its responsibilities under the Trade and Intercourse Act on behalf of the alleged Mashpee Tribe engendered undue reliance on the part of the private defendants that they had valid title to the subject land. The third-party plaintiffs sought reimbursement from the United States in the event they were deprived of their land as a result of a violation of the Trade and Intercourse Act.

claims was made contingent upon the creation of the Narragansett Corporation "to acquire, perpetually manage, and hold the settlement lands" and the conveyance by the State of Rhode Island of the public settlement lands to the Narragansett Corporation. (P.L. 95-395, § 7). Provision was also made in the Act for the approval of prior transfers and extinguishment of land claims involving other Indian tribes in Rhode Island. (P.L. 95-395, §13). Thus, as a result of the willingness of the State of Rhode Island and the private defendants to convey their land, the entire State of Rhode Island, including the Town of Charlestown, was freed from the threat of economic hardship caused by both actual and potential Indian land claims.

The State of Rhode Island has also enacted settlement legislation known as the "Narragansett Indian Land Management Act." This Act established a "permanent, public corporation of the State . . . to be known as the 'Narragansett Indian Land Management Corporation'" which was authorized to acquire and manage the settlement lands "for the benefit of the descendants

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7 [continued]

Although the third-party complaint in the Mashpee case was dismissed on grounds of sovereign immunity, it is the Narragansett defendants' position that the subsequent voluntary appropriation of $3.5 million to compensate private landowners who agreed to convey their land as part of the Narragansett settlement constitutes an acknowledgement of the United States' moral, if not legal, responsibility for alleged violations of the Trade and Intercourse Act in states such as Rhode Island.

of those individuals of Indian ancestry set forth in the list established purusant to Public Laws 1880, Chapter 800, Section 4." (State Legislation, § 3). The Narragansett Corporation is to be administered by a board of nine directors, five of whom are to be appointed by the Narragansetts. The remaining four directors are to be selected by the Governor, Town Council and Speaker of the House and Majority Leader of the Rhode Island Senate. (State Legislation, § 5). As contemplated in the Settlement Agreement, the Narragansett Corporation is exempt from local taxation and is empowered to establish its own hunting and fishing regulations. (State Legislation, §§ 8, 9).

V. DEFERRAL OF THE RECOGNITION OF GAINS OCCURRING AS A RESULT OF THE CONVEYANCE OF LAND BY THE PRIVATE DEFENDANTS TO THE NARRAGANSETT CORPORATION IS CONSISTENT WITH THEPOLICY ESTABLISHED BY SECTION 1033.

Section 1033 of the Internal Revenue Code provides for the deferral of the recognition of capital gains "[i]f property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted. . . ." Judge Learned Hand has stated that the basic policy established by this section is that "[a]n owner whose property is taken involuntarily, but who has become entitled to compensation, should not be treated as having 'realized' [sic] a taxable 'gain,' provided he at once puts the proceeds to a similar use." Winter Realty & Constr. Co. v. C.I.R., 149 F.2d 567, 569 (2d Cir. 1945). Thus, it is "the forced character of the disposition plus the . . . replacement of involuntarily converted property with like property

[that establishes] the justification for the non-recognition provision." 3 Mertens, Law of Federal Income Taxation, § 20.167 at 776.

Insofar as is relevant, for a conveyance to qualify as an "involuntary conversion" three criteria must be met:

1. The conveyance must result from governmental compulsion.
2. The compulsion must constitute a condemnation, or at least a threat of condemnation.
3. The condemnation must be for a public purpose.

The Internal Revenue Service has defined the term "condemnation" as "the process by which private property is taken for public use without consent of the property owner but upon award and payment of just compensation." Rev. Rul. 57-314, 1957-2, C.B. 523. See also, Behr-Manning Corp. v. United States, 196 F. Supp. 129, 133 (D. Mass. 1961); Dear Publication & Radio, Inc. v. C.I.R., 274 F.2d 656, 660 (3rd Cir. 1960); American Natural Gas Co. v. United States, 279 F.2d 220, 225 (Ct. Cl. 1960). Involuntariness alone is insufficient to permit the application of § 1033.

On the face of the Agreement, it would appear that the private defendants agreed to convey their land voluntarily to the Narragansett Corporation. In general, section 1033 does not apply to sales of property where the owner may choose to keep his property, because in such circumstances the necessary element of compulsion is often lacking. C.G. Willis, Inc. v. Comr., 41 T.C. 468, aff'd per curiam, 342 F.2d 996 (3rd Cir. 1966). However, in S & B Realty Co. v. Comr., 54 T.C. 863, 870-872 (1970), the Tax Court held that a taxpayer who was faced with the threat of

condemnation if he did not expend funds to upgrade his property pursuant to an urban renewal plan could avail himself of the provisions of § 1033 despite the existence of alternatives which would enable him to retain his property. The existence of the option to retain the property by making improvements did not obviate the threat or imminence of condemnation. 54 T.C. at 870. According to the court, § 1033 relief should not be denied in such circumstances because the opportunity to retain the property ". . . neither assuages the compulsion nor contravenes the intent of Congress." Id.

The initiation of the lawsuits put the private defendants on notice that the Narragansetts intended to assert their right to possession of the land as an "Indian tribe or nation" pursuant to the provisions of the Trade and Intercourse Act. Although the private defendants had the option of refusing to sign the Settlement Agreement and litigating the validity of the Narragansetts' claim, the "threat" or possibility that they would lose their land clearly existed. The financial burden of defending the lawsuits dictated the necessity of reaching a settlement. The subsequent determination by the Secretary of the Interior that the Narragansetts had a "credible claim" to the land also raised the possibility that the United States might have joined in the lawsuits, as it intends to do in Maine, if a settlement had not been reached. See, Passamaquoddy, supra. The conveyance of the private defendants' property to the Narragansett Corporation cannot be viewed in isolation apart from the threat

established by the pendency of the lawsuits. As the court stated in S & B Realty, supra at 870, the absolute certainty of governmental action in the absence of a sale is not necessary for a "threat" of condemnation to exist:

> "It is significant that the word 'threat' was used in section 1033. This is indicative of the fact that the statute does not require that the possibility of condemnation be reduced to a certainty. Any reasonable construction of the word must recognize the possibility that the impending, undesirable consequence may never occur. The crucial factor is that the petitioner was compelled by this impending consequence to take evasive action."

The private defendants' sale of their property is not readily distinguishable from the sale of property under the threat of condemnation for which non-recognition treatment was upheld in S & B Realty, supra.

While a threat to the defendants' land clearly existed, the question remains as to whether their disposition of their property to the Narragansett Corporation resulted from a threat of condemnation.[8] As mentioned above, the word "condemnation"

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8 In Richmond Hotels, Inc. v. United States, 75-2 U.S.T.C. (1975), the court set forth three requirements in order for a sale to qualify as being made because of the threat or imminence of condemnation:

1. A reasonable belief by the taxpayer that a threat to condemn was present;
2. Readily obtainable authority to condemn or actual authority to condemn or no reasonable grounds to believe that such authority was not readily obtainable; and
3. A sale made because of the alleged threat or imminence of condemnation.

means "a taking of property by public authority for public use." Behr-Manning Corp., supra at 133. In this regard, the Narragansett land claim shares many of the attributes of a condemnation proceeding.

If the Narragansetts had successfully litigated their claim to the land, title to the defendants' property would have become vested in an "Indian tribe or nation" which, under the laws of the United States, constitutes a semi-sovereign entity. Indeed, had the United States joined in the lawsuits in the exercise of its fiduciary responsibility toward the tribe, the defendants' property might have been conveyed to the Narragansetts as a ward of the United States.[9]

In point of fact, the land in question is to be conveyed to the Narragansett Corporation, a "permanent, public corporation of the State." (State legislation §3). Also, a public purpose was clearly served by the defendants' agreement to sell their land. As part of the settlement, all Indian claims in Rhode Island were eliminated, thereby cutting short the economic hardships caused by the pendency of the lawsuits. While neither the Narragansetts nor any other Indian tribe possess the power of condemnation as literally defined, it is clear that the threat of the taking via the lawsuits emanated from a public

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9 In Heckman v. United States, 224 U.S. 413, 439 (1912), the Court held that "[a] transfer of the [Indian land] is not simply a violation of the proprietary rights of the Indian. It violates the governmental rights of the United States." (emphasis added).

entity. The sale of the land to the Narragansett Corporation provides a direct and tangible benefit to the public as a whole, not just to the individual defendants.

In Narragansett, despite the fact that the private defendants' property was to be conveyed under the threat of forfeiture to a public instrumentality and that such conveyances served a distinct public interest, we recognize that the sellers' right to § 1033 treatment is not clearcut in the absence of the proposed legislation. If the Narragansetts had successfully prosecuted their claim, it would have meant that the defendants did not have a valid possessory interest in the property which was superior to that of the Narragansetts.[10] The absence of a superior possessory interest could negate the concept of "taking" which entitles the defendants to compensation. See, Dorothy C. Thorpe Glass Mfg. Corp. v. C.I.R., 51 T.C. 300, 303-304 (1968).

We believe that the defendants did have a sufficient interest in the land to be entitled to compensation. The question of whether or not there has been a Fifth Amendment "taking" turns on the peculiar circumstances of each case. United States v. Central Eureka Mining Co., 357 U.S. 155, 168 (1958). A "taking" occurs if the acts of the government make it possible for another to

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10 Such a finding would not mean that the defendants had no interest whatsoever in the property. With the exception of the Narragansetts, the defendants interest in the land is superior to that of any other party.

have the benefits of the property. E.g., Eyherabide v. United States, 345 F.2d 565, 570 (Ct. Cl. 1965). It is the loss of property and not the accretion of that property directly to the government that describes a "taking". See, United States v. Causby, 328 U.S. 256, 261 (1946).

If the court decided the Narragansetts had the right to possess the land, the resulting dislocation of the defendants would have been caused by the continuing failure of the federal government to exercise properly its fiduciary responsibilities toward the Narragansetts, thereby engendering undue reliance on the part of the property owners that their title was good. It would be manifestly unjust to simply eject landowners who for almost one hundred years had an apparently valid chain of title to the land as a result of the Federal Government's failure to exercise its fiduciary responsibilities. We believe that the Federal Government acknowledged the inequity of such a scenario when it agreed to appropriate $3.5 million to compensate the defendants for conveying their land to the Narragansett Corporation.

Section 1033 is "a relief measure designed to prevent inequitable incidence of taxation, and therefore to be construed liberally to effectuate its purpose", Creative Solutions, Inc. v. United States, 320 F.2d 809, 811 (5th Cir. 1963). The instant case nonetheless presents a novel situation. No case has yet held that the United States, acting in a fiduciary capacity for the benefit of an Indian tribe, would be condemning property for a public or quasi-public use if it were to prosecute alleged violations of the Trade and Intercourse Act. Even though the exercise of the power of the United States on the Narragansetts'

behalf would appear to be the equivalent to the taking of land for a public purpose and therefore within the scope of § 1033 as a matter of statutory construction, in light of the unique situation created by Indian land claims the defendants' right to § 1033 treatment should be resolved by legislative rather than administrative means.

VI. CONCLUSION

The private defendants have an equitable, and in our view should have a legal, right to § 1033 treatment. Their land was threatened by a semi-sovereign Indian tribe and, potentially the United States of America, in its trustee capacity toward the Narragansetts. The land was conveyed under the threat of complete forfeiture to a public instrumentality, the Narragansett Corporation. The agreement of the private defendants to sell their land served a direct public purpose. The acquisition of the land was financed by the Federal Government, a tacit acknowledgment that the landowners had a right to compensation. We are compelled to believe that had the framers of §1033 ever envisioned that this situation could occur, they would have included loss of land as a result of Indian land claims such as in Narragansett within the scope of that section.

In addition to these factors, it must be remembered that a commitment was made by the Administration during the negotiation of the Agreement to the landowners who participated in the settlement that they would receive § 1033 treatment. This commitment cannot be broken without discouraging landowners in other Indian land claims suits from participating in future settlement agreements. In light of the clear-cut consistency of the proposed legislation with the goals and purposes of §1033, we urge the Senate Finance Committee to endorse the last outstanding element of the Rhode Island Indian land settlement.

THE FOLLOWING EXHIBITS REFERRED TO IN THE TEXT OF THIS MEMORANDUM ARE ATTACHED TO FIVE COPIES OF THE MEMORANDUM WHICH WERE DELIVERED TO THE SENATE FINANCE COMMITTEE:

EXHIBIT A - Joint Memorandum of Understanding Concerning Settlement of the Rhode Island Indian Land Claims

EXHIBIT B - Letter dated March 29, 1979 from Donald P. Quinn to Don L. Ricketts, Assistant Chief of Staff, Joint Committee on Taxation, 1015 Longworth, House Office Building, Washington, D.C. 20515, regarding the status of certain other Indian claims in the United States

EXHIBIT C - Photocopy of Public Law 95-395 entitled "Rhode Island Indian Claims Settlement Act"

EXHIBIT D - Letter dated May 10, 1979 from Cecil Andrus, Secretary of the Department of the Interior, to J. Joseph Garrahy, Governor of the State of Rhode Island, together with a copy of the State of Rhode Island Act Establishing the Narragansett Indian Land Management Corporation

EXHIBIT E - Copy of the House Report pursuant to the Joint Congressional Committee Hearings on the Narragansett Indian Claims Settlement Act

EXHIBIT F - Copy of the Senate Report pursuant to the Joint Congressional Committee Hearings on the Narragansett Indian Claims Settlement Act

EXHIBIT G - Copy of the proposed Senate 687, which is the subject of this hearing

EXHIBIT H - Letter from H. Gregory Austin, Solicitor, United States Department of the Interior, to Honorable Joseph E. Brennan, then Attorney General of the State Maine, regarding the final draft litigation reports on the Maine Indian claims

EXHIBIT I - Copy of Summons and Amended Complaint in the suit brought by Narragansett Tribe of Indians in the present case

EXHIBIT J - 1880 Rhode Island Act to abolish the tribal authority and tribal relations of the Narragansett Tribe of Indians

EXHIBIT K - Letter dated April 4, 1901 from Department of the Interior to James N. Arnold, Esq., a Rhode Island attorney, stating that the affairs of the Narragansett Indians are not under Federal control

EXHIBIT L - Letter dated June 29, 1927 from the Department of the Interior to Daniel Sekater, stating that "the Narragansett Indians have never been under the jurisdiction of the Federal Government..." and that "they are under the jurisdiction of different states of New England."

EXHIBIT M - Letter dated January 25, 1935 from John M. O'Connell, stating "it is believed that the Narragansett Indians come under the definition of 'Tribe'..." and further that "the Narragansett Tribe is not a recognized Indian Tribe now under Federal jurisdiction". This exhibit contains certain other letters to individuals in Rhode Island from Bureau of Indian Affairs.

EXHIBIT N - Letter dated June 28, 1978 from the Solicitor of the Department of the Interior to Senator James Abourezk, Select Committee on Indian Affairs, responding to the Committee's request regarding Interior's views of S. 3153, which ultimately was enacted into the Narragansett Indian Claims Settlement Act

TESTIMONY OF:

Edward I. Geffner
Administrative Director
Manhattan Bowery Corporation

INTRODUCTION

Good Morning, Mr. Chairman and Members of the Finance Committee. My name is Edward Geffner. I am the Administrative Director of the Manhattan Bowery Corporation, located at 8 East 3rd Street, New York, N.Y. 10003, and I am here to testify about S 401, a bill introduced by Senator Moynihan for the relief of the Manhattan Bowery Corporation.

First, I would like once again to thank Senator Moynihan and the members of his staff for their diligent efforts in drafting and introducing this bill and the members of this Committee for the opportunity to testify. Congressman Weiss, the principal sponsor of the bill in the House of Representatives and Congresswoman Holtzman and Congressman Rangel, co-sponsors,have also been most helpful.

My oral testimony will consist of a summary of a statement I have prepared. The Summary and the full statement have been submitted to the Committee, and I would like now to request that they be incorporated into the record.

SUMMARY

The Manhattan Bowery Corporation is a not-for-profit corporation which treats skid-row alcoholics in several locations in New York City offering detoxification, outpatient and residential treatment programs. During the twelve years since it was formed, the Corporation has helped thousands of Bowery men, many of whom have recovered, maintained their sobriety, and found employment.

Manhattan Bowery is seeking relief from assessments of F.I.C.A. taxes, interest and penalties which stem from the confusion that arose in 1974 concerning the requirement of § 3121(k) of the Code that not-for-profit corporations file waivers of their exemption from F.I.C.A. tax liability to secure Social Security coverage for their employees.

Since its inception in 1967, the Corporation has withheld F.I.C.A. taxes from employees' salaries and paid these sums plus the employer's contribution to the Internal Revenue Service. In 1974, the Internal Revenue Service became aware that many not-for-profit organizations were making F.I.C.A. contributions without the legal authority to do so since they had not filed the required waivers. Manhattan Bowery was concerned because the Treasury had ruled that employees of organizations that had not filed a waiver would not be covered by the Social Security laws. After a diligent search of its files the Corporation could not locate the waiver. It wrote to the Internal Revenue Service for advice and was informed that if it wished to secure Social Security coverage for its employees, it would have to file a waiver which would be retroactive for a five-year period. However, at the time a waiver is filed employees may either elect to participate in the Social Security system or be exempt from F.I.C.A. taxes.

Manhattan Bowery filed a waiver in April, 1975, but many employees chose not to participate, and therefore they and the Corporation were

entitled to a refund of F.I.C.A. taxes previously paid. The Corporation also stopped withholding F.I.C.A. taxes from the salaries of those who elected tax exemption.

During 1975, the Corporation received refund checks totalling $174,918.28. It distributed the employees' share and retained the remainder in a separate bank account to return ot its funding agencies. In March of 1977, the Corporation received notices of tax due. Upon inquiry, the Service stated that it had determined that the Corporation had filed a waiver in 1968 and therefore Manhattan Bowery must pay both the employer's and employees' share of F.I.C.A. taxes for the period January 1, 1973 through June 30, 1977,plus interest and penalties.

The Corporation paid $75,423.44 of the asserted liability of $160,867.37,plus interest and penalties. It is unable to pay the entire amount. Its income is derived from government contracts and grants to provide alcoholism services. Counsel for the government agencies has determined that they are prohibited by law from authorizing the use of funds they provide to satisfy the Internal Revenue Service's claim. Moreover, the Service did not assert its claim until two years after the filing of the 1975 waiver and claims for refunds. Many employees had left in the interim and it is largely impossible to collect their share plus the interest and penalties.

The Service has filed a lien on the Corporation's assets and bank accounts. If it forecloses the liens the Corporation will have to cease operations, thereby stopping services contracted for by the Department of Health, Education and Welfare and the New York City Department of Mental Health, Mental Retardation and Alcoholism Services. The net result will be to transfer funds from one government agency to another.

Moreover, the Service is largely responsible for this state of affairs since it had several opportunities to inform Manhattan Bowery that a waiver had been filed, but neglected to examine its records.

The Treasury will not suffer financially if the bill is enacted. The employer's share will be paid and employees who want coverage will have to pay their share, i.e., the full amount due for Social Security coverage. For employees who do not elect coverage, the government will receive a gratuitous payment from Manhattan Bowery.

TESTIMONY

The Manhattan Bowery Corporation

The Manhattan Bowery Corporation is a New York not-for-profit corporation, exempt from federal taxation pursuant to § 501(c)(3) of the Internal Revenue Code. The Corporation was organized to offer medical treatment of alcoholism as a humane alternative to jail* and has been engaged continuously in the treatment and rehabilitation of homeless alcoholics. For this purpose, the Corporation operates several programs in New York City:

(1) the Manhattan Bowery Project, a detoxification ward located in the Shelter Care Center for Men, 8 E. 3rd Street, which provides medical care during a five-day detoxification period;

(2) an outpatient department located in the same building which provides long-term rehabilitation therapy;

(3) the West Side Social Setting Alcoholism Treatment Center, an experimental detoxification unit located at 124-30 W. 60th Street;

(4) STEP I, a six-month residential treatment program for alcoholics who have completed detoxification, located on Jane and West Streets in Greenwich Village;

(5) STEP II, a similar program located in the Stratford Arms Hotel on W. 70th Street;

(6) Project Renewal, a halfway house and work program located on Fort Greene Place in Brooklyn;

(7) Phase II, an employment program for rehabilitated alcoholics who have undergone a basic course in the construction trades.

* Prior to the inception of the program, 3,200 Bowery men were arrested annually for drunkenness as compared with 31 men in 1977.

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The New York City Police Department contributes five police officers and three patrol cars to the operations of the Corporation. The Department of Social Services contributes space, utilities, food, clothing and other materials for patients. The New York City Department of Mental Health, Mental Retardation and Alcoholism Services (DMH), the New York State Department of Mental Hygiene and the National Institute on Alcohol Abuse and Alcoholism provide over 95% of the Corporation's operating funds. The success of the program and its importance in the treatment of alcoholism in New York City is amply attested to in the attached letter from Dr. George Jurow, first Deputy Commissioner of the DMH. (See Attachment I)

In addition to its work in New York City, the Manhattan Bowery Corporation has gained a national reputation. It has acted as a consultant, for example, in Cincinnati, Ohio; Sacramento, California; Boston, Massachusetts; Rochester, New York; Finland and England, in establishing programs for public inebriates. All this has been accomplished while operating with a budget that was initially parsimonious and has been frozen at a reduced level due to New York's fiscal crisis.*

The F.I.C.A. Tax Problem

Since its inception in 1967, the Corporation had been withholding Social Security taxes from its employees' wages and paying over these trust fund monies and the employer's share of Social Security taxes to the IRS in accord with the provisions of the Federal Insurance Contributions Act. In late 1974, however, the Corporation, along with many other

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* For a complete description of the Corporation's history and operations see its ten-year report, available from the Corporation.

charitable organizations,* became aware of the exemption from F.I.C.A. tax liability provided by section 3121(b)(8)(B) of the Code. After a diligent search of its records, the Corporation concluded that it had not filed a waiver of this exemption pursuant to section 3121(k) of the Code. The Corporation was therefore in doubt both as to the status of payments already made and as to the proper procedure in the future. In a letter dated September 20, 1974, the Corporation requested a ruling from the Internal Revenue Service as to the treatment of amounts already paid in order to resolve these doubts. (See Attachment III). Specifically, the Corporation requested that it be permitted to file a waiver effective as of the first date for which it had collected social security taxes. The Service responded in a letter dated January 16, 1975. (See Attachment IV). The letter stated that section 3121(k)(1)(B)(iii) limited the effective date of a waiver to within five years preceding the filing date, and that the Service was without authority to grant relief from this provision. However, the letter also noted that the Social Security Administration (the agency responsible for record-keeping in these matters) would adjust only credited quarters within the previous three years, three months, and fifteen days; it would not disturb earlier records. Thus, although the Corporation and its employees had paid F.I.C.A. taxes for the period 1971 through 1974 and were continuing to do so, there was no guarantee that the Corporation's employees would be fully credited by the Social Security Administration for that period.

* For a fuller description of the history of the problem, see 122 Cong.Rec., H 11887-90 (daily ed.Sept.30,1976) Attachment II.

In these circumstances, the Corporation determined that, as it wished the benefits of Social Security coverage for its employees, it should file a waiver pursuant to section 3121(k). The Corporation filed this waiver (Form SS-15) on March 31, 1975. It was made effective as of April 1, 1970, the earliest date permited by section 3121(k)(1)(B). In connection with this filing, the Corporation gave its then employees the opportunity to concur in the filing or to remain exempt from F.I.C.A. taxes, as required by section 3121(k)(1)(A) and as referred to in the Internal Revenue Service letter of January 16, 1975. Employees who wished to concur did so by signing Form SS-15a, which was duly filed with the Service. Employees who did not concur were, of course, entitled to refunds of the erroneously collected F.I.C.A. taxes and the Corporation was likewise entitled to a refund of its F.I.C.A. taxes paid with respect to these employees.

During early 1975 the Corporation made this situation known to its employees, obtained the signatures of concurring employees on Form SS-15a, and filed refund claims as to its other employees. The refund claims were filed by the Corporation on its own behalf and on behalf of those employees not concurring on Form SS-15a.*

* 150 of the Corporation's former and current employees elected to receive a refund (since three former employees did not respond to our notice, 147 actually received a refund); 24 elected not to have F.I.C.A. taxes withheld from their future wages (only 21 were still employed at the time the election became effective). Between July and November of 1975, the Corporation received refund checks amounting to $174,918.28 including $1,003.35 interest. $90,773.78 of this amount was distributed to current and former employees and the remainder deposited in a bank account pending an accounting to determine the funding agencies to which the money should be returned. (Ordinarily the Corporation's share would be one half of the total reimbursement. However, due to an error the IRS did not refund $3,314.64 due the Manhattan Bowery Corporation and a like amount to its employees for the quarter ending December 31, 1972, and the Corporation elected to make full payment to its employees while awaiting correction of the error. The error was never corrected.)

In April, 1977, the Corporation received four notices of tax due (Form 3552), dated April 4, 1977, asserting additional F.I.C.A. taxes, plus interest, for the 1973 calendar year (one notice for each quarter). In late April or early May, 1977, the Corporation received five additional notices, dated April 25, 1977, covering the four quarters of 1974 and the first quarter of 1975. The total liability asserted, with interest or penalties, amounted to $122,745.25.

Upon inquiry, the Corporation was advised by the Service that the Social Security Administration claimed to have on file an earlier Form SS-15 waiver by the Corporation. Therefore, the Service took the position that F.I.C.A. taxes were in fact due with respect to all employees for the period 1971 through 1975, as a valid waiver had been in effect since 1968.

The Corporation immediately requested a copy of the alleged waiver. In response to this request, a document was ultimately received on August 8, 1977. However, it was not, in fact, a Form SS-15 waiver; it was instead a copy of a Form SS-15a "List to Accompany Certificate on Form SS-15", stamped as received August 15, 1968 and showing the names of thirty-five employees. The Corporation has been informed that it was the practice of the Social Security Administration to destroy Form SS-15 waivers five years after filing. If the 1968 Form SS-15 waiver of the Corporation ever existed, it has since been destroyed.

During the latter part of 1977 the Corporation paid a substantial portion of the asserted liability, amounting to approximately $62,718.94 of F.I.C.A. taxes and $12,705.50 of interest and late payment penalties.

In late 1977, it came to the attention of the Corporation that F.I.C.A. taxes were not being collected or paid with respect to employees who had not concurred in the 1975 waiver. If the 1975 filing was improper, as

the Service claimed, the then employees were subject to F.I.C.A. taxes and the Corporation was obliged to collect such taxes. This situation was reported to the Service and Forms 941-C were filed for the period April 1, 1975 to September 30, 1977. The Service sent additional notices of tax due, dated December 21, 1977, showing F.I.C.A. tax liability of $38,122.12, plus interest and penalties.

The Corporation's Dilemma

After the Corporation received the notices of tax due and a copy of the form SS-15A, it notified the State and local government agencies which provided funds for its operations and requested permission to pay the asserted obligation. Several meetings were held and the Corporation was informed by counsel for the New York City Department of Mental Health, Mental Retardation and Alcoholism Services - the agency funding the Corporation's activities during the period the alleged obligation arose - that New York law prohibited the payment of the Internal Revenue Service claim with funds provided pursuant to a contract with the Department. * Because the Department had already performed its obligation to provide the salaries of all employees during the contract periods, from its point of view, it would be paying that portion of the salaries that should have been deducted for F.I.C.A. taxes twice. Since the Corporation has no income it can spend nor any assets it can use without the approval of government agencies, it is unable to pay the Internal Revenue claim.

The Corporation has submitted an Offer-in-Compromise to the IRS. However, we have been informed by the Service that the process is a lengthy one and that the outcome is uncertain. In addition, since the Service requires that the Offer consist of at least the Trust fund monies, the Corporation would have to pay over $57,000 if the Offer were accepted, substantially more than it would if the bill is enacted. If the bill is enacted the

* See: Article 41 of the Mental Hygiene Law.

Corporation would have to pay an additional $16,032.54.

The Service has filed a lien against the Manhattan Bowery Corporation's assets to assure payment. Should the Service foreclose the lien, the funding agencies would stop all payments to Manhattan Bowery, forcing it to cease operations. The Internal Revenue Service would not receive full payment on its claims and Manhattan Bowery Corporation's clientele would be deprived of services.

The situation is somewhat bizarre. One department of government, the Internal Revenue Service, is trying to return to the Treasury monies which have been appropriated by the Congress and the New York State legislature to be spent by the National Institute on Alcohol Abuse and Alcoholism and the New York City Department of Mental Health, Mental Retardation and Alcoholism Services to provide for the public welfare.

Indeed, a great part of the responsibility for the present state of affairs must rest on the government's poor record-keeping procedures. On three separate occasions the government should have discovered the waiver allegedly filed in 1968 in its records. The first opportunity came upon receipt of the letter from the Corporation, dated September 20, 1974. At that time, the Service was aware that there was widespread confusion about waivers and that a potentially serious problem was brewing.* Thousands of not-for-profit corporations which had not filed waivers were paying F.I.C.A. taxes.+ These corporations and their employees were entitled to refunds for taxes previously paid and to discontinue payments of F.I.C.A. taxes -- a potentially serious

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* See: 122 Cong.Rec. H 11887 (daily ed. Sept.30, 1976) (Remarks of Mr. Mikva).

\+ Id. H 11887, H 11889 (Remarks of Congressmen Ullman and Ottinger).

drain on the Social Security trust fund. Various departments of the government were fully aware of serious taxpayer confusion. In these unusual circumstances some attempt should have been made, upon receipt of the Corporation's letter, to ascertain whether the Corporation had filed an initial waiver.

A second opportunity arose March 31, 1975, when the Corporation filed a form SS-15 waiver. If a waiver was actually filed in 1968, a proper filing system should have disclosed immediately that the 1975 document duplicated the earlier filing. By accepting the 1975 filing, the Service confirmed the Corporation in its belief that an initial waiver had not been filed.

Finally, knowing the widespread confusion among not-for-profit organizations over this matter, the Service nevertheless processed claims for a large refund without verifying them by a search of its own files. Had the Corporation been informed of the alleged error soon after the refunds were paid to employees, it could probably have recovered virtually all of the amounts paid over. With the passage of time, this has become largely impossible. Many employees who received refunds are no longer with the Manhattan Bowery Corporation, and for all practical purposes, are unreachable.

The Legislation

The bill before the Committee would require that the Corporation pay the employer's share of F.I.C.A. taxes for the period January 1, 1973 - June 30, 1977 while relieving it of responsibility for almost all of the employees' share and all penalties and interest. It would have the Secretary of the Treasury refund the $75,424.44 in taxes, penalties and interest already paid. These monies, together with the remainder of the employer's share of the original refund

which the Corporation still has in the bank, would enable the Corporation to pay the entire employer's share for that period.

The Treasury would receive a payment of about $91,000 and would not be obliged to credit employees for wages for the quarters in questions unless each employee agreed to pay his/her share of the F.I.C.A. taxes. Thus, the Treasury at worst, would receive full statutory payment for the benefits Social Security must provide. However, the more likely result is that employees will not elect coverage or are no longer with the Corporation and the Treasury will receive the $91,000 and not have to pay benefits.

ATTACHMENT I

DEPARTMENT OF MENTAL HEALTH
AND MENTAL RETARDATION SERVICES
93 WORTH STREET, NEW YORK, N. Y. 10013
Telephone: 566-4830
JUNE J. CHRISTMAS, M.D., Commissioner
GEORGE L. JUROW, Ph.D., J.D., First Deputy Commissioner

March 27, 1978

To Whom It May Concern:

Re: Manhattan Bowery Corporation

Since its inception ten years ago, the Manhattan Bowery Corporation has been in contract with the New York City Department of Mental Health, Mental Retardation, and Alcoholism Services. The Corporation is critical to the Department's planning for the provision of alcoholism services in New York City, because it is the single largest provider of services to the homeless adult male alcoholic population.

The Corporation operates six separate programs. Two of these, located at the Men's Shelter in Manhattan, are the Manhattan Bowery Project and the Outpatient Clinic, and are especially significant because of their special location near the Bowery, the area most severely affected by alcoholism in the entire city.

The Manhattan Bowery Project provides inpatient medical detoxification services to adult males in a 48 bed unit, which handles three thousand admissions a year. The Project provides twenty-four hour emergency services including emergency transport to the Project, which is essential not only to the population treated but to the surrounding community. Efforts to contain and treat the transient alcoholic population could not proceed without the work of the Bowery Project.

The Outpatient Clinic provides psychiatric, nursing, and other supportive services to former inpatients as well as to the large alcoholic population which does not require actual hospitalization. The caseload for this clinic is 18,400 visits a year.

In addition to these services, the Manhattan Bowery Corporation administers a nonmedical detoxification center in midtown Manhattan with 35 beds, and three residential programs. Two of the residential programs are located on the Upper West Side in Manhattan, and the third, which includes a supported work program, is located in Brooklyn. Once former alcoholics are sober, such facilities play an important role in the rehabilitation and dispersion of the formerly homeless Bowery population. Thus the Corporation's group of programs provide a network of services crucial to the City in achieving its mandate to plan for treatment of the City's indigent alcoholic population.

Throughout the City, the Manhattan Bowery Corporation enjoys an excellent reputation. Its programs are nationally recognized and acclaimed, and have been the model for similar programs in other areas of the country. In this Department's extensive dealings with the Corporation on program issues and in contract

negotiations, the Corporation has always conducted business in a highly professional manner, in complete good faith, and with conformance to the highest ethical standards. Should it come to pass that the Manhattan Bowery Corporation had to close its life sustaining programs, it is beyond speculation or mere sensationalism to predict that the number of deaths in New York City due to alcoholism would sharply increase. Any termination of the Corporation's services would also have a profoundly negative impact on the quality of the surrounding local community and neighborhood. There is no means, financially or physically, by which this Department or any other municipal or private entity could, within a short period of time, intervene and provide the services which would be lost.

In sum, because of the critical value of its programs to the residents of the City of New York, its high professional standards, and its integrity, I feel compelled to express my concern and support for the Manhattan Bowery Corporation.

Sincerely,

George L. Jurow, Ph.D.
First Deputy Commissioner

GLJ:mc

ATTACHMENT II

act if it has not received a refund or credit of such taxes, and to require the filing of such a certificate by any nonprofit organization which paid such taxes but received a refund or credit because it had not previously filed such certificate, which was unanimously reported favorably to the House by the Committee on Ways and Means.

The Clerk read the title of the bill.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon?

Mr. CONABLE. Mr. Speaker, reserving the right to object I wonder if the distinguished chairman would care to describe this bill further for the Members.

Mr. ULLMAN. Mr. Speaker, would the gentleman yield to the author of the bill, the gentleman from Illinois (Mr. MIKVA)?

Mr. CONABLE. I yield to the gentleman from Illinois.

Mr. MIKVA. I thank the gentleman for yielding.

This bill is intended to correct a situation that has developed that could both penalize a great many senior citizens who are expecting social security coverage, as well as be a drain on the social security funds.

Under the existing social security laws, a not-for-profit organization's employees are not covered by the social security laws, and the only way they can be covered is if the organization files an exemption certificate, which is a written piece of paper that it is supposed to file with the Social Security Administration. Most not-for-profit organizations over the years have not known about this technical requirement and have paid in both for themselves and their employees for a long period of time.

The Treasury ruled approximately a year or so ago that, given the state of the law, they had to insist that unless the organization had filed a waiver, those employees were not covered notwithstanding the fact that moneys had been paid in for them to the social security for years and years. That is how the employees would get undone.

But then, in addition, the Treasury ruled that for a period of 3 years refunds could be obtained by the employees of the organizations which could amount to a several hundred million dollar drain on the social security funds.

This bill really says that where an organization has paid in for a period of time, that will be deemed a course of action the same as if they had filed a waiver. Their employees would be covered, and no refunds would be allowed.

Mr. CONABLE. I wonder if the gentleman would correct me. I have some understanding of this bill, but I would like to be sure it is correct. Would the gentleman tell me if anything in what I say in further elucidation is incorrect?

It is my understanding that H.R. 15571 was introduced to deal with a problem involving certain nonprofit tax-exempt organizations and their employees.

Under section 210(a) of the Social Security Act and section 3121(k) of the Internal Revenue Code, employees of these organizations may be covered under social security if the organizations file certificates waiving their tax exemptions for social security purposes. The problem is that many of these organizations have been paying social security taxes for years, but have not filed proper certificates. In these cases, there is no social security coverage, and the affected organizations and their employees may claim a refund of all social security taxes paid within periods covered by the statute of limitations—3 years, 3 months, and 15 days. A substantial number of these organizations and their employees have received refunds.

H.R. 15571 would deal with this problem by providing that the payment of social security taxes by any such organization would constitute a retroactive "constructive filing" of the required certificate.

More specifically, the bill would provide that—

First. Those organizations which have paid the taxes and have not received a refund would be deemed to have filed a proper certificate, when they began paying the taxes.

Second. Those organizations which have received a refund would have 180 days, after enactment of this measure, to file a waiver certificate voluntarily. If they do so, their employees who desire coverage would be listed and the list would be submitted along with the waiver. The organization and its individual employees would be required to pay back the amounts of refunds received.

Third. Organizations which have received a refund but do not file a new waiver within the 180-day period would be deemed to have filed such a waiver on the 181st day after enactment. The waiver would be deemed to cover all employees for whom social security taxes were paid. Such organizations would be solely liable for both employer and employee taxes for the retroactive period. The Internal Revenue Service would have the discretion to establish a reasonable extended period for the repayment of such taxes.

These are my basic assumptions about this bill, if the gentleman from Illinois will confirm them.

Mr. MIKVA. Those assumptions are correct.

Mr. CONABLE. Mr. Speaker, further reserving the right to object, I wonder if anybody would like to add anything further or ask any questions on this bill?

Mr. ULLMAN. If the gentleman will yield, the gentleman is right in every instance. Between my friend, the gentleman from New York, and the sponsor of the bill, the gentleman from Illinois (Mr. MIKVA), I think they have covered in a good way the content of this legislation. H.R. 15571 is intended to stem the development of an emerging problem that could result in a substantial drain on the social security trust funds.

The bill relates to social security taxes that have been paid by a number of nonprofit organizations that have not followed all of the requirements of the law that should have been taken to extend social security coverage to their employees. The Internal Revenue Service has determined that all of the taxes paid by such organizations and their employees will have to be refunded unless the organizations file waiver certificates that are effective retroactively to cover the 3-year statute of limitations period in the Social Security Act.

Mr. Speaker, under present law, employees of a nonprofit organization are excluded from social security coverage unless the organization files with the Internal Revenue Service a certificate waiving its exemption from taxation. Coverage may be provided retroactively for up to 5 years before the calendar quarter in which the waiver is filed. Employees of the organization at the time the waiver certificate is filed are given the option to participate in the program and, if they decide to do so, must sign a form accompanying the certificate waiving their right of exemption. All employees subsequently hired by the organization are automatically covered under the program. After a waiver certificate has been in effect for 8 years, an organization may terminate it after giving 2 years' advance notice.

There is substantial evidence that a large number of nonprofit organizations and their employees have been paying social security taxes even though the organizations have not filed a valid waiver certificate necessary to waive such organizations' exemption from social security tax liability and extend coverage under the program to their employees. The Internal Revenue Service has determined that such nonprofit organizations and their employees are entitled to a refund of social security taxes paid during the statute of limitations period—approximately 3 years—and when a refund is made the social security credits earned by an organization's employees during the statute of limitations period are canceled.

The General Accounting Office has conducted a study of this situation and estimates that in 1975 around 13,000 to 20,000 nonprofit organizations that had not filed a waiver certificate were paying social security taxes ranging from around $118 million to $369 million.

Turning now to a brief explanation of the bill, H.R. 15571 would provide that in cases in which a nonprofit organization and its employees have paid social security taxes for at least three consecutive calendar quarters and continuing to within the statute of limitations period, without having filed a valid waiver certificate, but no refund or credit of such taxes has been made prior to September 9, 1976, the organization would be deemed to have filed a valid waiver certificate effective beginning with the period for which such taxes were paid. This would validate the social security coverage of employees of such nonprofit organizations for whom social security taxes have been paid.

Those organizations that have received a refund or credit of taxes would have 180 days after enactment of the bill to voluntarily file a waiver certificate and a list of concurring employees. A nonprofit organization that does not file a waiver certificate within 180 days after enactment of the bill would be deemed to have filed on the 181st day

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after enactment a waiver certificate for all employees for whom social security taxes were paid. In order to avoid putting an undue hardship on these nonprofit organizations and their employees who would be required to repay the refunds they have received the bill provides that the payment of retroactive taxes would be permitted to be made in installments.

Mr. Speaker, this bill is clearly an emergency measure. If Congress does not act on it before adjournment, by next year it will be too late to enact effective legislation. The Internal Revenue Service has stated that in the absence of this legislation it will initiate a program to notify all of the nonprofit organizations that have been paying social security taxes without having followed the technical requirements of the law and advise them to either accept a refund of such taxes for the last 3 years or more or to file a valid waiver certificate.

Presumably most of these organizations will file waiver certificates since they mistakenly believed that they were already doing all that the law required of them. Since all of their employees, however, will have to be informed of their right to have their social security taxes for the last 3 years or more refunded, there will be a strong inducement for them to choose to take the refund and thereby lose their social security coverage while they remain in the employ of such organizations.

Mr. Speaker, this bill has the support of the administration. The Social Security Administration has indicated that some people now receiving social security benefits will lose their entitlement to benefits if the bill is not enacted. This matter has come to the attention of the Senate Finance Committee and it has added provisions identical to H.R. 15571 to another bill pending before it. I am sure that the Senate will take action on this matter after it passes the House. I strongly urge the passage of the bill.

Mr. CONABLE. Mr. Speaker, if I may say, this illustrates one small problem in a very troubled Social Security Administration. We are going to have to do a lot of pattern setting in this area next year not only because of problems of this sort but also because of the potential of a serious erosion of the payments into the system. We are also going to have to deal with the long-term and short-term actuarial problems with social security. This is only a stopgap measure designed to deal with a specific problem relating to nonprofit organizations.

Mr. MIKVA. Mr. Speaker, if the gentleman will yield one further moment, I would like to add something.

Mr. CONABLE. I yield to the gentleman from Illinois.

Mr. MIKVA. Mr. Speaker, I think a great deal of credit is due to the gentleman from New York (Mr. OTTINGER) and after it was brought to the attention of the committee to the gentleman from Massachusetts (Mr. BURKE).

Mr. CONABLE. I agree with what the gentleman said with respect to the two gentleman and what the gentleman said with respect to the need for action at this time.

Therefore, Mr. Speaker, I withdraw my reservation of objection.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon as to consideration of the bill?

There was no objection.

The Clerk read the bill as follows:

H.R. 15571

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 210(a)(8)(B) of the Social Security Act is amended—

(1) by inserting after "filed pursuant to section 3121(k) of the Internal Revenue Code of 1954" in the matter preceding clause (i) the following: "(or deemed to have been so filed under paragraph (4) or (5) of such section 3121(k))";

(2) by inserting after "filed" in clauses (i), (ii), and (iii) the following: "(or deemed to have been filed)"; and

(3) by striking out "is in effect" in the matter following clause (iii) and inserting in lieu thereof "is (or is deemed to be) in effect".

(b) Section 3121(b)(8) of the Internal Revenue Code of 1954 (relating to exclusion of certain services from definition of employment) is amended—

(1) by inserting after "filed pursuant to subsection (k) (or the corresponding subsection of prior law)" in the matter preceding clause (i) the following: "or deemed to have been so filed under paragraph (4) or (5) of such subsection";

(2) by inserting after "filed" in clauses (i), (ii), and (iii) the following: "(or deemed to have been filed)"; and

(3) by striking out "is in effect" in the matter following clause (iii) and inserting in lieu thereof "is (or is deemed to be) in effect".

(c) Section 3121(k) of such Code (relating to exemption of religious, charitable, and certain other organizations) is amended by adding at the end thereof the following new paragraphs:

"(4) CONSTRUCTIVE FILING OF CERTIFICATE WHERE NO REFUND OR CREDIT OF TAXES HAS BEEN MADE.—

"(A) In any case where—

"(i) an organization described in section 501(c)(3) which is exempt from income tax under section 501(a) has not filed a valid waiver certificate under paragraph (1) of this subsection (or under the corresponding provision of prior law) as of the date of the enactment of this paragraph or any subsequent date, but

"(ii) the taxes imposed by sections 3101 and 3111 have been paid with respect to the remuneration paid by such organization to its employees, as though such a certificate had been filed, during any period (subject to subparagraph (B)(i)) of not less than three consecutive calendar quarters,

such organization shall be deemed (except as provided in subparagraph (B) of this paragraph) for purposes of subsection (b)(8)(B) and section 210(a)(8)(B) of the Social Security Act, to have filed a valid waiver certificate under paragraph (1) of this subsection (or under the corresponding provision of prior law) on the first day of the period described in clause (ii) of this subparagraph effective on the first day of the calendar quarter in which such period began, and to have accompanied such certificate with a list containing the signature, address, and social security number (if any) of each employee with respect to whom the taxes described in such subparagraph were paid (and each such employee shall be deemed for such purposes to have concurred in the filing of the certificate).

"(B) Subparagraph (A) shall not apply with respect to any organization if—

"(i) the period referred to in clause (ii) of such subparagraph (in the case of that organization) terminated before the end of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of the enactment of this paragraph, or

"(ii) a refund or credit of any part of the taxes which were paid as described in clause (ii) of such subparagraph with respect to remuneration for services performed on or after the first day of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of enactment of this paragraph (other than a refund or credit which would have been allowed if a valid waiver certificate filed under paragraph (1) had been in effect) has been obtained by the organization or its employees prior to September 9, 1976.

"(5) CONSTRUCTIVE FILING OF CERTIFICATE WHERE REFUND OR CREDIT HAS BEEN MADE AND NEW CERTIFICATE IS NOT FILED.—In any case where—

"(A) an organization described in section 501(c)(3) which is exempt from income tax under section 501(a) would be deemed under paragraph (4) of this subsection to have filed a valid waiver certificate under paragraph (1) if it were not excluded from such paragraph (4) (pursuant to subparagraph (B)(ii) thereof) because a refund or credit of all or a part of the taxes described in paragraph (4)(A)(ii) was obtained prior to September 9, 1976; and

"(B) such organization has not, prior to the expiration of 180 days after the date of the enactment of this paragraph, filed a valid waiver certificate under paragraph (1) which is effective for a period beginning on or before the first day of the first calendar quarter with respect to which such refund or credit was made (or, if later, with the first day of the earliest calendar quarter for which such certificate may be in effect under paragraph (1)(D)(iii)) and which is accompanied by the list described in paragraph (1)(A),

such organization shall be deemed, for purposes of subsection (b)(8)(B) and section 210(a)(8)(B) of the Social Security Act, to have filed a valid waiver certificate under paragraph (1) of this subsection on the 181st day after the date of the enactment of this paragraph, effective for the period beginning on the first day of the first calendar quarter with respect to which the refund or credit referred to in subparagraph (A) of this paragraph was made (or, if later, with the first day of the earliest calendar quarter falling wholly or partly within the time limitation (as defined in section 205(c)(1)(B) of the Social Security Act) immediately preceding the date of the enactment of this paragraph), and to have accompanied such certificate with a list containing the signature, address, and social security number (if any) of each employee described in subparagraph (A) of paragraph (4) including any employee with respect to whom taxes were refunded or credited as described in subparagraph (A) of this paragraph (and each such employee shall be deemed for such purposes to have concurred in the filing of the certificate). A certificate which is deemed to have been filed by an organization on such 181st day shall supersede any certificate which may have been actually filed by such organization prior to that day except to the extent prescribed by the Secretary or his delegate.

"(6) APPLICATION OF CERTAIN PROVISIONS TO CASES OF CONSTRUCTIVE FILING.—All of the provisions of this subsection (other than subparagraphs (B), (F), and (H) of paragraph (1)), including the provisions requiring payment of taxes under sections 3101 and 3111 with respect to the services involved, shall apply with respect to any cer-

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tificate which is deemed to have been filed by an organization on any day under paragraph (4) or (5), in the same way they would apply if the certificate had been actually filed on that day under paragraph (1); except that—

"(A) the provisions relating to the filing of supplemental lists of concurring employees in the third sentence of paragraph (1)(A), and in paragraph (1)(C), shall apply to the extent prescribed by the Secretary or his delegate;

"(B) the provisions of paragraph (1)(E) shall not apply unless the taxes described in paragraph (4)(A)(ii) were paid by the organization as though a separate certificate had been filed with respect to one or both of the groups to which such provisions relate; and

"(C) the action of the organization in obtaining the refund or credit described in paragraph (5)(A) shall not be considered a termination of such organization's coverage period for purposes of paragraph (3). Any organization which is deemed to have filed a waiver certificate under paragraph (4) or (5) shall be considered for purposes of section 3102(b) to have been required to deduct the taxes imposed by section 3101 with respect to the services involved.

"(7) BOTH EMPLOYEE AND EMPLOYER TAXES PAYABLE BY ORGANIZATION FOR RETROACTIVE PERIOD IN CASES OF CONSTRUCTIVE FILING.—Notwithstanding any other provision of this chapter, in any case where an organization described in paragraph (5)(A) has not filed a valid waiver certificate under paragraph (1) prior to the expiration of 180 days after the date of the enactment of this paragraph and is accordingly deemed under paragraph (5) to have filed such a certificate on the 181st day after such date, the taxes due under section 3101, with respect to services constituting employment by reason of such certificate for any period prior to the first day of the calendar quarter in which such 181st day occurs (along with the taxes due under section 3111 with respect to such services and the amount of any interest paid in connection with the refund or credit described in paragraph (5)(a)) shall be paid by such organization from its own funds and without any deduction from the wages of the individuals who performed such services; and those individuals shall have no liability for the payment of such taxes.

"(8) EXTENDED PERIOD FOR PAYMENT OF TAXES FOR RETROACTIVE COVERAGE.—Notwithstanding any other provision of this title, in any case where an organization described in paragraph (5)(A) files a valid waiver certificate under paragraph (1) by the end of the 180-day period following the date of the enactment of this paragraph as described in paragraph (5)(B), or (not having filed such a certificate within that period) is deemed under paragraph (5) to have filed such a certificate on the 181st day following that date, the taxes due under sections 3101 and 3111 with respect to services constituting employment by reason of such certificate for any period prior to the first day of the calendar quarter in which the date of such filing or constructive filing occurs may be paid in installments over an appropriate period of time, as determined under regulations prescribed by the Secretary or his delegate, rather than in a lump sum.".

(d) The amendments made by this section shall apply with respect to services performed after 1950, to the extent covered by waiver certificates filed or deemed to have been filed under section 3121(k) (4) or (5) of the Internal Revenue Code of 1954 (as added by such amendments).

SEC. 2. Notwithstanding any other provision of law, no refund or credit of any tax paid under section 3101 or 3111 of the Internal Revenue Code of 1954 by an organization described in section 501(c)(3) of such Code which is exempt from income tax under section 501(a) of such Code shall be made on or after September 9, 1976, by reason of such organization's failure to file a waiver certificate under section 3121(k)(1) of such Code (or the corresponding provision of prior law), if such organization is deemed to have filed such a certificate under section 3121(k)(4) of such Code (as added by the first section of this Act).

SEC. 3. In any case where—

(1) an individual performed service, as an employee of an organization which is deemed under section 3121(k)(5) of the Internal Revenue Code of 1954 to have filed a waiver certificate under section 3121(k)(1) of such Code, at any time prior to the period for which such certificate is effective;

(2) the taxes imposed by sections 3101 and 3111 of such Code were paid with respect to remuneration paid for such service, but such service (or any part thereof) does not constitute employment (as defined in section 210(a) of the Social Security Act and section 3121(b) of such Code) because the applicable taxes so paid were refunded or credited (otherwise than through a refund or credit which would have been allowed if a valid waiver certificate filed under section 3121(k)(1) of such Code had been in effect) prior to September 9, 1976; and

(3) any portion of such service (with respect to which taxes were paid and refunded or credited as described in paragraph (2)) would constitute employment (as so defined) if the organization had actually filed under section 3121(k)(1) of such Code a valid waiver certificate effective as provided in section 3121(k)(5)(B) thereof (with such individual's signature appearing on the accompanying list),

the remuneration paid for the portion of such service described in paragraph (3) shall, upon the request of such individual (filed in such manner and form, and with such official, as may be prescribed by regulations made under title II of the Social Security Act) accompanied by full repayment of the taxes which were paid under section 3101 of such Code with respect to such remuneration and so refunded or credited, be deemed to constitute remuneration for employment as so defined. In any case where remuneration paid by an organization to an individual is deemed under the preceding sentence to constitute remuneration for employment, such organization shall be liable (notwithstanding any other provision of such Code) for repayment of any taxes which it paid under section 3111 of such Code with respect to such remuneration and which were refunded or credited to it.

Mr. OTTINGER. Mr. Speaker, I am grateful to the members of the Ways and Means Committee, and particularly to the gentleman from Illinois (Mr. MIKVA), for taking action on H.R. 15571 and pleased that we are able to take it up as a unanimous consent request today. I also want to give particular thanks to Chairman ULLMAN, Subcommittee Chairman BURKE, the gentleman from Florida (Mr. GIBBONS) and my colleague from New York (Mr. CONABLE) for their invaluable help.

Time is of the essence in this matter if we are to avoid costly refunds from the social security trust fund to organizations that have failed to comply with a minor technicality in the law which the GAO has estimated could run as high as $1 billion.

This legislation cosponsored by Congressman MIKVA and me is needed to protect an estimated 13,000 to 20,000 voluntary organizations and their employees who have been paying social security taxes without having filed a prescribed form SS15, a waiver of exemption. Nonprofit organizations were excluded prior to 1950 from participation in the Social Security program. In 1950 legislation was passed allowing nonprofit organizations to provide social security coverage for their employees if they chose to do so, but required them to waive their exclusion under the law by filing this Form SS15 with the Internal Revenue Service.

Many of these organizations and their employees, estimated by GAO as some 13,000 to 20,000 nationwide, have been paying social security taxes without ever filing the form SS15. The IRS, despite the fact that it cheerfully accepted the taxes without notifying the organizations or their employees of any problem, has ruled that failure to file the form negates Social Security coverage. It also concluded that it is under a legal obligation to refund all tax payments to the organizations and their employees upon application, but only insofar as refunds are permitted under the statute of limitations—3 years and 3 months of payments. An organization which applies for a refund automatically deprives its employees of social security coverage. Thus, employees of non-profit organizations who have worked and paid social security taxes for 20 years can lose all coverage and be eligible for refund of these taxes paid for only 3 years, 3 months. Furthermore, these refunds have the potential for placing a serious drain on the social security trust fund.

The bill that has been reported from Ways and Means Committee would accomplish the following:

First. Organizations which have been paying taxes but have not filed the SS15 waiver nor received a refund will simply be deemed to have filed the waiver and will continue paying as before. Coverage for participating employees will be validated.

Second. Organizations which have received a refund will have 180 days to file a waiver on behalf of those employees who want their coverage restored. Both employer and employee will be responsible for the accumulated back taxes if the back coverage is to be restored. Employees have the option of keeping their refunds and remaining outside the Social Security system. Payment of back taxes can be made in installments over an extended period. Prospective coverage only is also available to those people under a provision of current law.

Third. Organizations that received refunds and which fail to file the SS15 by the end of 180 days will be deemed to have filed on the 181st day on behalf of all those employees who took the refund. In this case back taxes will be paid by the organization. This provision was put in the bill because it was feared that if there were not some strong incentive for the refunded organization to file on behalf of those employees who want back into the program, many of them would simply take no action.

Mr. Speaker, over the past few weeks we have had discussions with both the agencies involved in this matter—the Treasury Department and the Social Security Administration—as well as with

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representatives of some 30 to 40 of the largest nonprofit groups in the country. The bill we are considering today is the product of input from all these sources. It has the strong support of the administration and of the nonprofit organizations. To my knowledge not one person or party has come forward to express opposition to the measure.

I think I can truthfully say that this is about as noncontroversial a measure as I have seen. It does not cost us anything, and could save the trust fund as much as $1 billion.

I would just like to add that this bill has been favorably reported by the Senate Finance Committee, which agreed last week to attach it as an amendment to a House-passed bill, H.R. 6048. If we can get it through the House, it can be held at the desk in the Senate. Since it has the support of the Finance Committee members, I am confident that it will be voted upon and passed by the full Senate.

The bill was ordered to be engrossed and read a third time, was read the third time, and passed, and a motion to reconsider was laid on the table.

GENERAL LEAVE

Mr. ULLMAN. Mr. Speaker, I ask unanimous consent that I may revise and extend my remarks on this bill and that all Members may have 5 legislative days in which to revise and extend their remarks on this legislation.

The SPEAKER. Is there objection to the request of the gentleman from Oregon?

There was no objection.

THE INDIAN TRIBAL GOVERNMENTAL TAX STATUS ACT

Mr. ULLMAN. Mr. Speaker, I ask unanimous consent for the immediate consideration of the bill (H.R. 8983) to amend the Internal Revenue Code of 1954 to provide the same tax exemptions and general tax treatment to recognized Indian tribes as are applicable to other governmental units, which was unanimously reported favorably to the House by the Committee on Ways and Means.

The SPEAKER pro tempore. Is there objection to the request of the gentleman from Oregon?

Mr. FRENZEL. Mr. Speaker, reserving the right to object, I yield to the distinguished chairman of the House Ways and Means Committee so that he may describe the bill for the House.

Mr. ULLMAN. I thank the gentleman for yielding.

Mr. Speaker, this bill amends the Internal Revenue Code to provide to recognized Indian tribes and Alaskan Native villages the same tax treatment that is applicable to other governmental units. This series of changes treats recognized Indian tribes and Alaskan Native villages similar to States for the purpose of determining whether the tribes and villages can issue tax-exempt municipal bonds and industrial development bonds, and the same as States for determining whether taxes paid to and charitable contributions made to the tribes and villages are deductible and for certain other income and excise tax purposes.

Indian tribes and Alaskan Native villages perform many of the same governmental functions as do municipal and State governments. These functions include law enforcement, water, sewage and garbage services, business licensing and regulation, land use planning, housing, social and health programs, legal services, natural resource development and other activities. In order to assist the Indian tribes and Alaskan Native villages in carrying out their self-governing responsibilities, those tribes which perform substantial governmental functions should be provided with substantially the same tax status enjoyed by other governmental units.

An amendment to present tax law is necessary because the status of these units is not stated explicitly in the code. As a result, certain of the governmental functions cannot be performed. Specifically, the Internal Revenue Code does not exempt Indian tribes from taxation, but the Internal Revenue Service has ruled that "Income tax statutes do not tax Indian tribes. The tribe is not a taxable entity." Nevertheless, the ruling by the Service does not grant the tribes and villages authority to issue tax-exempt municipal and industrial development bonds.

The bill generally gives to recognized Indian tribes the tax treatment now available to State governments. The term "recognized Indian tribe" includes any tribe, band, community, village, or group of Indians or Alaska Natives which is recognized by the Secretary of the Treasury, after consultation with the Secretary of the Interior, as performing substantial governmental functions. This definition is intended to provide tax treatment as governmental units to the same Indian tribes and Alaskan Native villages which are treated as governmental units for certain revenue sharing purposes under the State and Local Fiscal Assistance Act of 1972. Three hundred and forty-seven groups are at present listed as eligible for revenue sharing entitlements under the act.

A major effect of the bill is to permit recognized Indian tribes to issue debt obligations that pay interest which is exempt from income taxation. However, tax-exempt treatment is not to be available for interest on any obligation—other than an industrial development bond—issued by a recognized Indian tribe if all or a major portion of the proceeds are to be used directly or indirectly in any commercial or industrial activity. In the case of industrial development bonds, the exemption is to apply only if: First, the principal activities of the trade or business financed with the proceeds of the bonds are carried on in the area reserved by Federal statute, Executive order, or treaty to the Indian tribe issuing the bonds, and second, substantially all of the activities of the trade or business which are carried on outside of the reservation area are purchasing, marketing, or similar activities directly related to the activities carried out within the reservation area.

In addition, the bill provides beneficial tax treatment with respect to pension and retirement income and contributions, charitable contributions, excise taxes, tribal income and real property taxes and certain unrelated business income. The bill also provides that certain tribal officials are to be "government officials" for purposes of the tax on self-dealing between a private foundation and a disqualified person.

The tax provisions apply to taxable years and other actions after September 30, 1977.

Mr. FRENZEL. Mr. Speaker, I rise in support of H.R. 8983, which would grant to recognized Indian tribes the same general tax treatment as is now applicable to other governmental units. Under present law, Indian tribes are not specifically exempt from taxation. However, the Internal Revenue Service has ruled that such tribes are not taxed under the income tax statutes inasmuch as the tribe is not a taxable entity.

The Indian tribes and Alaskan Native villages affected by this bill perform many of the governmental functions performed by municipal and State governments, including law enforcement, water, sewage and garbage services, business licensing and regulation, social and health programs, et cetera. The Ways and Means Committee concluded that in order to assist these tribes and Native villages in the discharge of their governmental responsibilities, those tribes performing substantial governmental functions should receive essentially the same tax treatment as that enjoyed by other governmental units.

H.R. 8983 would extend to these recognized Indian tribes and Alaskan Native villages the same tax treatment now available to State governments. A recognized Indian tribe would include any tribe, band, community, et cetera, recognized by the Secretary of the Treasury, following consultation with the Secretary of the Interior, as one which performs substantial governmental functions.

Specifically, the bill would provide favorable tax treatment to such tribes with regard to retirement income derived from employment by a tribe, contributions which are made to persons seeking election to tribal office, interest on bonds issued by such tribes, including industrial development bonds, scholarship and fellowship grants made by tribes, taxes levied by tribes on real property, charitable contributions to tribes, and a number of other activities as to which favorable tax treatment is now available to other State and local governments.

With regard to these changes in the law, one of the bill's major effects is to permit these recognized Indian tribes to issue debt obligations, the interest upon which will be tax exempt for Federal income tax purposes. However, this tax treatment will not be available on interest on any obligation, other than industrial development bonds, which is issued by a tribe if all or the major portion of the proceeds from such debt is to be used either directly or indirectly in any industrial or commercial activity.

I believe that this bill makes needed and justifiable changes in the law and

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ATTACHMENT III

MANHATTAN BOWERY PROJECT
[illegible] EAST 3RD STREET
NEW YORK, N.Y. [illegible]
[illegible]

MIR BAKER, JR
ENT AND CHAIRMAN,
TTAN BOWERY CORPORATION
RT R. MORGAN, M.D.
T MEDICAL DIRECTOR
N E. MANOS
E ADMINISTRATIVE DIRECTOR
OF TRUSTEES
TTAN BOWERY CORPORATION
DAVIS
H T. ENGLISH, M.D.
P. FERGUSON
I. GRACE, M.D.
KISSIN, M.D.
ARY C. MASTERS
CIA GARLAND MORISEY
PADILLA
RT RAMIS
RICK A. O. SCHWARZ, JR.
RT STURZ
Y A. TOMPKINS, M.D.

September 20, 1974

Commissioner
Internal Revenue Service
Washington, D.C. 20025

Dear Sirs:

The Manhattan Bowery Corporation (the "Project") is a not-for-profit corporation organized under the laws of New York State and is tax exempt under Section 501(c)(3) of the Internal Revenue Code. The Project provides a range of alcoholism services, from detoxification through rehabilitation, for disaffiliated alcoholics of New York City.

The Project, through an oversight, failed to file a waiver of exemption from Social Security, although it intended that its employees be covered from its inception in 1967. Now, planning to file an SS-15, the Project would like a ruling that its present and former employees will receive credit for Social Security payments made during the life of the Project.

The relevant facts follow:

1. The Project was incorporated as a not-for-profit corporation in New York State on October 27, 1967.

2. The Project's status as a 501(c)(3) corporation was confirmed in a letter of determination dated April 29, 1968, for the period ending June 30, 1968. The Project has at all times maintained this status.

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3. Since the inception of its operations in the second half of 1967, the Project has intended to participate in Social Security and to have its employees covered. It has therefore paid the employer's share and collected the employee's contribution on all applicable salaries and wages from its first day to the present.

4. No waiver of the exemption from the applicability of the Social Security laws has been filed, but the Project now intends to file an SS-15.

Filing raises the following question. Section 3121(K)(2), C.F.R. states in effect that upon filing of an SS-15 by the corporation and an SS-15(a) by an employee, that employee's coverage will date back up to five years from the effective date of the SS-15. This provision would work an inequity for any employee, either current or formerly employed, whose period of employment included time that would be counted toward Social Security if the five-year limitation were not applied.

We understand, from a conversation with Mr. Ronald Steinkritz, a revenue agent in the Manhattan payroll tax group, that it is possible to obtain a waiver of the five-year limitation so that full coverage for any period when Social Security taxes were paid may be elected by an individual filing an SS-15(a).

We feel that granting of such a waiver is equitable in the circumstances stated above. The Project intended its employees to be covered; failure to obtain coverage was inadvertent; full payment of taxes has been made as if coverage were in effect. We therefore request that you grant a waiver of the five-year limitation to the Project and its employees.

We would be grateful for your prompt action on this request. Please call me if there are questions about this letter.

Sincerely,

Steven S. Manos

SSM/[illegible]

cc: R. Palmer Baker, Jr.

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ATTACHMENT IV

Phone Contact: Mrs. Mary L. Spates
Phone Number: (202) 964-3292
Jerry Holmes
(964-4488)

Internal Revenue Service

JAN 1 6 1975

T:I:EA:1:2

Manhattan Bowery Project
8 East 3RD Street
New York, New York 10003

Attention: Steven S. Manos

Gentlemen:

This is in reply to your letter dated September 20, 1974 in which a ruling is requested with respect to the status of the organization's employees under the Federal Insurance Contributions Act (FICA).

According to the information furnished, the Manhattan Bowery Project (Project), which provides care and assistance to disaffiliated alcholics in New York City, was incorporated as a not-for-profit organization in New York on October 27, 1967 and its status as a 501(c)(3) organization was confirmed in a letter of determination dated April 29, 1968.

You state that it was the intent of the Project from its inception to have its employees covered by social security and accordingly the FICA taxes have at all times since the Project was organized been deducted and paid. However, through an oversight, Form SS-15, Certificate Waiving Exemption from taxes Under the Federal Insurance Contributions Act was not filed and the Project now requests a ruling that it be permitted to file an SS-15 with an effective date retroactive to the period when the organization first began deducting and paying the FICA tax. This action has been requested to insure that the Project's present and former employees will receive credit for all earnings previously reported.

Under section 3121(b)(8)(B) of the Internal Revenue Code, an organization described in section 501(c)(3) of the Code is exempt from the taxes imposed by the FICA. A charitable or other organization wishing to obtain social security coverage for its employees, may however, file an SS-15 together with a Form SS-15a containing the names, if any, of employees who concur in the filing. Individuals who are employees at the time the Form SS-15 is filed have an option of electing coverage by signing the Form SS-15a or a Form SS-15a Supplement within twenty-four months of the date of the filing. Individuals who are hired

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Manhattan Bowery Project

after the quarter in which the Form SS-15 is filed are automatically covered under the Form SS-15.

Section 3121(k)(1)(B) of the Code provides in pertinent part that the certificate shall be in effect for the period beginning with whichever of the following may be designated by the organization . . ."

> (iii) the first day of any calendar quarter preceding the calendar quarter in which the certificate is filed, except that such date <u>may not be earlier</u> than the first day of the twentieth calendar quarter preceding the quarter in which such certificate is filed.

Thus the law with respect to the effective date which may be elected by an organization when it files an SS-15 is very specific and we are without statutory authority to grant relief of the type which you have requested in that the Project's activities began more than five years ago.

If you file your Form SS-15 with a retroactive date of 20 quarters (5 years), an individual who is an employee of the Project at the time the Form SS-15 is filed has an option with respect to his social security coverage. If he wishes to continue coverage he must sign the Form SS-15a at the time the Form SS-15 is filed. He may also obtain coverage by filing a Form SS-15a Supplement within 24 months of the filing of the Form SS-15a. If he does not wish to continue his social security coverage, he will be entitled to a refund of the tax erroneously withheld up to the statutory limitations for refunds. You will find the procedures for making adjustments and refunds of erroneously withheld FICA taxes outlined on the reverse of the Form 941.

It is our understanding from the Social Security Administration that under its regulations, earnings records will not normally be revised after three years, three months and 15 days. Thus, even though the Form SS-15 may be made retroactive for a period of 5 years only, the earnings prior to that time not covered by the Form SS-15 would not be disturbed. However, since earnings records and the payment of benefits come within the jurisdiction of the Administration, we would suggest any further questions you may have in that respect be directed to your local Social Security district office.

We are enclosing a copy of Revenue Procedure 67-35 published in our Cumulative Bulletin 1967-2 at page 662 which may answer further questions you may have with respect to filing the waiver certificate.

Sincerely yours,

William H. Rogers
Chief, Employment Tax and Administrative Provisions Branch

Enclosure

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Senator BYRD. Dr. Sanford?

STATEMENT OF JAY P. SANFORD, M.D., DEAN, SCHOOL OF MEDICINE, UNIFORMED SERVICES UNIVERSITY OF THE HEALTH SCIENCES, BETHESDA, MD.

Dr. SANFORD. Mr. Chairman, I am Jay Sanford, dean of the School of Medicine, Uniformed Services University of the Health Sciences, representing Mr. David Packard, the Chairman of our Board of Regents. Mr. Packard was not able to be here today, but he has a statement that we would like to submit for the recórd.

Senator BYRD. Without objection it will be inserted into the record.

Dr. SANFORD. I would just like to, very briefly, clarify points with regard to this legislation.

As you are aware, the Uniformed Services University was established in 1972 as an institution to train military and other uniformed physicians.

At the time of the enactment of the legislation, it was the view of those involved that to acquire a quality faculty, it would be necessary to have civilian faculty be reimbursed on a salary schedule that was comparable with their colleagues in the civilian sector. This included not only salary schedules, but fringe benefits.

In July 1975, the Secretary of Defense authorized the university to proceed to provide tax-deferred retirement annuities to its faculty members. I might say, of the 126 medical schools in the country, all of them have such authorization.

At the same time, we requested of the Internal Revenue Service authority to do so.

As a Federal agency, we are not eligible under 501(c)(3). The same had arisen with regard to State universities in 1960 when the Internal Revenue Service ruled the same and legislation was passed stating that educational institutions within States or their subdivisions would be eligible to qualify under section 403(b).

We have brought this to the Internal Revenue Service but they point out that that legislation specified State and political subdivisions thereof and we, in fact, are the Federal Government. Therefore, we do not qualify under either of these and I feel that the only recourse that we have is to come to you for such legislation.

I emphasize again that this is not tax exemption, this is tax deferral in a manner similar to other types of tax-deferred annuities. The total dollars involved are very small. We currently have 79 faculty members participating in this. The dollars involved are less than $50,000 per annum.

Senator BYRD. Thank you.

I have a statement in support of the legislation by Senator Mathias which I will insert in the record at this point.

[The statement of Senator Mathias follows:]

TESTIMONY OF SENATOR CHARLES McC. MATHIAS, JR.

Mr. Chairman, thank you for the opportunity to testify today on S. 945. The bill would allow the faculty and staff of the Uniformed Services University of the Health Sciences, located in Bethesda, Maryland, to participate in the tax-sheltered annuity program enjoyed by their colleagues in other medical schools. As you know, your distinguished colleagues on the Finance Committee, Senator Boren and Sena-

tor Chafee, have joined me as cosponsors of this bill. Last year a similar bill was passed in the House.

The University was designed to provide top quality medical educations for people who would serve in the United States armed services. Congress left the Unversity's charter deliberately broad in order "to make this the finest medical school in the world in the shortest possible time," according to the Uniformed Services Health Professions Revitalization Act.

I don't have to tell this Committee that the Internal Revenue Code is extremely precise in its distinctions, and it is very clear that only state schools and private schools are eligible to participate in the annuity program. Since the University is an instrument of the federal and not a state government, it has been repeatedly denied authorization from the IRS to participate in the program, which is available to every other medical school in the country.

To deny benefits to the faculty and staff of the University sets back our efforts to make the University the "finest medical school in the world." S. 945 will allow an annuity contract bought by the University for its employees who are members of the civilian faculty or staff to be treated as if the University were a State-funded school, or a charitable organization. That means that the faculty and staff of the University would be able to take advantage of a significantly beneficial tax shelter. And the University will be on equal footing competitively with other medical schools in the nation.

I hope that this Committee will find it appropriate to correct this anomally in the law. The men and women who are striving to make the University the best in the world have earned this vote of confidence.

Senator BYRD. I might point out that the Treasury Department does not believe that this represents sound tax policy. However, the Treasury statement says, in the context of the present law, the Treasury does not oppose S. 945.

The Treasury, however, does suggest a change in the effective date of the bill. S. 945 provides that it will apply to services performed after December 1, 1977, in taxable years ending after such date.

Treasury does not believe that it is appropriate to provide for a retroactive effective date.

Do you have a view on that comment?

Mr. SANFORD. Mr. Chairman, the date of 1977 was introduced at the time in the last session of the Congress, the same legislation was introduced into the House and was passed by the House and did not manage to get on the Senate calendar.

Senator BYRD. Would that give you any great problem, not to have it retroactive?

Mr. SANFORD. No, it would not. Obviously, we would prefer to have it, but it would not create a problem.

Senator BYRD. Thank you.

Senator Chafee?

Senator CHAFEE. Mr. Chairman, I think this is good legislation. We want to keep a top faculty at the Uniformed Services Medical School.

I know that Dean Sanford and Mr. Packard are working extremely hard. I am a cosponsor of this piece of legislation, incidentally, and support it.

Thank you.

Senator BYRD. Thank you, doctor.

[The prepared statement of Mr. Packard follows:]

STATEMENT OF DAVID PACKARD
CHAIRMAN, BOARD OF REGENTS
UNIFORMED SERVICES UNIVERSITY OF THE HEALTH SCIENCES

Mr. Chairman and members of the Committee, the Board of Regents of the Uniformed Services University of the Health Sciences appreciates the opportunity to present its views on S. 945 which would provide University faculty the benefits of tax-deferred annuities enjoyed by their colleagues at comparable schools.

The University was established in 1972 pursuant to P.L. 92-426 to train medical personnel for the uniformed services. Congress provided that a Board of Regents would conduct the business of the University.

The Board has overseen the construction of the school, from the groundbreaking in July 1975. The complex of buildings has just been completed, at a cost considerably less than the appropriation. This September our fourth class of medical students began classes.

The Board is also vested with the function of assembling a University faculty. The University's enabling legislation provides that:

> The Board . . . shall obtain the services of such . . . civilian professors . . . as may be necessary to operate the University. Civilian members of the faculty and staff shall be employed under salary schedules and granted retirement and other related benefits prescribed by the Secretary of Defense so as to place the employees

> of the University on a comparable basis with the employees of fully accredited schools of the health professions within the vicinity of the District of Columbia. (Underscore added)

Faculty recruitment for the medical school continues. As anticipated by the Congress, we have had to be competitive with comparable medical schools in order to attract an outstanding faculty.

An important aspect of comparability is the retirement program we offer. This is especially significant in recruiting distinguished senior faculty, the people who will most affect the curriculum's effectiveness and reputation. There is one prevailing retirement plan throughout the United States (and in the vicinity of the District of Columbia) that university faculty routinely expect as part of a benefit package. A part of this is the provision for tax-deferred annuities.

On July 15, 1975, the Secretary of Defense approved a tax-deferred annuity program for civilian faculty as part of the University's retirement package. Faculty were recruited expecting this to be included in the retirement program.

On July 23, 1975, the University asked the Internal Revenue Service to issue a ruling approving favorable tax treatment. In January 1976, the Internal Revenue Service ruled that:

> For an employee to be entitled to participate in a tax-sheltered annuity program as described in section 403(b), the employee

> must either (1) be employed by a State, a political subdivision of a State or an agency or instrumentality of the foregoing and perform services for an educational institution as defined in section 151(e)(4) of the Code, or (2) be employed by an organization described in section 501(c)(3) of the Code which is exempt from taxation under section 501(a) of the Code.
>
> Since the University apparently is an agency or instrumentality of the Federal government, and not an agency or instrumentality of a State or a political subdivision of a State, and since it apparently is not an organization described in section 501(c)(3) of the Code, we conclude that the University is not a qualified employer as described in section 403(b) and its employees are not eligible to participate in a tax-sheltered annuity program as described by that section.

The history of tax-deferred annuities at educational institutions may be of interest to the Committee.

Section 403(b) of the 1954 Code provided for tax-sheltered annuities where the annuity contract was purchased by an employer which was a tax-exempt organization described in Code Section 501(c)(3) (i.e., organized and operated exclusively for educational purposes, insofar as relevant here).

In 1955 the Internal Revenue Service ruled that an organization organized and operated exclusively for educational purposes could qualify under Section 501(c)(3) and provide the benefits of Section 403(b) tax-sheltered annuities to its employees, although it was already exempt from Federal income taxation as a wholly owned agency or instrumentality of State government. (Rev. Rul. 55-319, 1955-1 C.B. 119).

In 1960 the IRS amplified the 1955 ruling, holding that if the organization in question was being conducted under the jurisdiction of a branch or department which was an integral part of State or municipal government, the organization could not qualify as a Section 501(c)(3) organization and therefore could not offer tax-sheltered annuities. The reason was that the governmental functions of the branch or department by which it was being conducted would exceed the functions prescribed for a 501(c)(3) organization. (Rev. Rul. 60-384, 1960-2 C.B. 172).

Acting with dispatch, Congress in 1961 adopted an amendment to Code Section 403(b), designed to avoid the effect of the 1960 ruling and relieve the school supervised and conducted by a branch or department which was an integral part of State or municipal government of the necessity of qualifying as a 501(c)(3) organization before it would be entitled to the benefits of the tax-sheltered annuities in question. The reason for adopting the 1961 amendment is reflected in the Report of the Senate Committee on Finance on H.R. 4317 (Senate Report No. 379, 87th Cong., 1st Sess.). Referring to the restrictive position taken by the Internal Revenue Service in the 1960 ruling, the report stated:

> The Committee felt that it was not reasonable to take the view that Congress ever intended that State or local governmental units should be required to file application with the Commissioner for classification as a tax-exempt organization when the Federal Government has no power under the Constitution to tax the State or local government in the first place.

Tax-sheltered annuities under Code Section 403(b)(1)(A)(ii) are available to faculty at other medical schools, including those which are

an integral part of a branch or department of State or municipal government. However, the IRS adhered to its ruling position that the program was not available to the Uniformed Services University faculty. This was in spite of a letter from a former member of Congress, who had drafted the University's legislation, indicating that tax deferral was contemplated in the legislation. This letter stated:

> I am unable at this time to recall exactly when the provision quoted above was first brought up. I do recall, however, that when it was, the point was made most emphatically that it was desired to make it possible for the University to offer to its faculty and staff the same type of compensation benefits including tax sheltered annuities that were available at other medical schools throughout the country; that this would be absolutely essential if the USUHS was to be in a position to compete with the other medical schools for the best professional talent. It was mentioned that even the State medical schools had these benefits by specific code provision and that the USUHS should have the same benefits.
>
> I can assure you it was my understanding, and I am certain the other members of my committee concerned with this legislation were of the same mind, that we wanted the employees of the USUHS to have the same rights to tax sheltered annuities that were available under the Internal Revenue Code to employees of the other medical schools, including those owned and operated by a State or political subdivision thereof. I can give you the same assurance that the sentence in section 2113(f) of the statute quoted above was intended to provide those rights. It was never anticipated that the Code would be construed narrowly to exclude the USUHS employees from the benefits available to employees of virtually all other medical schools. Had that been forseen, the statutory provision would undoubtedly have been made more precise.
>
> It would be contrary to the Congressional intent, in my opinion, to deny these tax sheltered annuities to employees of USUHS.

I note that this is echoed in the Conference Committee Report, which states:

> (I)t was the general consensus of the conferees that the provisions, as written should remain deliberately broad

> so as to provide the Secretary of Defense and the Board of Regents, in establishing and administering the university, sufficient executive authority to ensure the kind of administrative flexibility that will be necessary to make this the finest medical school in the world in the shortest possible time.

The lack of tax-deferred annuities is an important issue to our faculty since they are being denied a benefit they would have at most other medical schools. In addition, the faculty we are recruiting express concern and are told we are attempting to provide the program. Certainly, when Congress provided this benefit to public schools in 1961, it would have included the University, had it existed. Since it did not yet exist, this bill provides a resolution of the issue.

As I'm sure you realize, the effect of this bill involves no additional budget outlay for the University and does not involve tax exemption, but tax postponement. University faculty participate in the Social Security System as well as the contributory faculty retirement plan.

The Regents support this bill as necessary to the University's continued development, and I appreciate the opportunity to present the Regents' point of view. The Regents and I are ready to provide any further assistance that you and the Committee desire and to answer any questions.

Senator BYRD. We have two additional bills; neither should take very long. S. 224 introduced by Senator Hatch.

The committee is very pleased that the Senator from Utah is present. The Senator from Utah will be recognized, but before that, the panel that will follow the Senator from Utah will consist of Mr. James M. Bodfish, president, Tax Executives Institute, accompanied by Mr. W. Dale Hay, chairman, Subcommittee on Fringe Benefits; and Mr. Converse Murdoch, president, Small Business Council of America.

Senator Hatch, you have introduced a very important piece of legislation, and we are pleased to be able to hold this hearing today and are more than delighted that you are here to present your observations.

Senator HATCH. Mr. Chairman, I have prepared a statement. Let me just put a little of it in and present the rest for the record.

STATEMENT OF HON. ORRIN HATCH, U.S. SENATOR FROM THE STATE OF UTAH

Senator HATCH. S. 224 is a bill designed to prevent the Treasury Department from issuing administrative regulations to include employee fringe benefits as a part of gross income for tax purposes. This bill should be acted upon promptly in this session and thus return to Congress the responsibility of levying taxes on employee fringe benefits, aid business and labor in future contract negotiations by ending speculation as to what the IRS might define as taxable income, to save taxpayers billions of dollars in additional taxes and avoid the cumbersome process of legislative veto in which Congress attempts to review and modify regulations put forth by an executive department.

Mr. Chairman, it is the constitutional duty of Congress to legislate tax policy and thus determine what portions of personal income is taxable. If there is a need to tax fringe benefits, politically sensitive elected officials in Congress should act, and not the IRS.

This is one responsibility that the Congress would be unwise to leave to the bureaucrats of an executive department.

Now, I have a number of pages of testimony that I would like to submit for the record.

Senator BYRD. The complete text of your testimony will be published at this point in the record, Senator.

Senator HATCH. Thank you, Mr. Chairman.

In addition, I would like to submit the article from U.S. News & World Report entitled "Forty Fringe Benefits the IRS Wants To Tax." I think that would aid and assist the committee to know a little about what the IRS has up its sleeve.

Senator BYRD. Yes, I think it would be well to have that in the record.

[The material referred to follows:]

PREPARED STATEMENT OF SENATOR HATCH

Mr. Chairman, S. 224 is a bill designed to prevent the Treasury Department from issuing administrative regulations to include employee fringe benefits as part of gross income for tax purposes. This bill should be acted upon promptly in this session and thus: Return to Congress the responsibility of levying taxes on employee fringe benefits, aid business and labor in future contract negotiations by ending speculation as to what the IRS might define as taxable income, save taxpayers

billions of dollars in additional taxes, and avoid the cumbersome process of legislative veto in which Congress attempts to review and modify regulations put forth by an executive department.

Mr. Chairman, it is the Constitutional duty of the Congress to legislate tax policy and thus determine what portion of personal income is taxable. If there is a need to tax fringe benefits politically sensitive elected officials in Congress should act, and not the IRS. This is one responsibility that Congress would be unwise to leave to the bureaucrats of an executive department.

Mr. Chairman, let me explain why the IRS should not be allowed to tax fringe benefits at its own discretion.

In 1975, a discussion draft containing a number of rules for determining whether various fringe benefits constitute taxable compensation was issued by the Treasury Department. According to these proposed regulations some employee fringe benefits not previously considered taxable, under prior administrative practice, would have become subject to taxation. Other benefits considered taxable would not have been taxed. In December of 1976 the Treasury Department withdrew the discussion draft. The reason being that the facts and circumstances in each individual case are so different that it makes it extremely difficult to determine what fringe benefits, if any, should result in taxable income to employees.

"Some fringe benefits, such as the provision of health insurance by an employer for its employees, are expressly excluded from gross income by the Internal Revenue Code; others are excluded by legislation outside the Code; and yet other exclusions are based on judicial authority or an administrative practice. Some fringe benefits have been excluded under administrative practice on the basis of a de minimis principle, i.e., accounting for the benefit would be unreasonable or administratively impractical. Other items are excluded due to a combination of valuation difficulties and widely held perceptions that the items do not constitute income." (Legislative History Public Law 95-427)

In *Commissioner* v. *Duberstein*, The United States Supreme Court struggled to formulate a standard to measure the compensatory nature of employee fringe benefits. The court then qualified the use of the inferences it arrived at by stating that they could not be viewed in absolute terms. If the United States Supreme Court could not define what indicia or circumstances would qualify a particular benefit to be characterized as taxable compensation, should Congress allow the IRS to choose arbitrarily which benefits to tax. Mr. Chairman, if Congress allows the IRS to open that "can of worms" it had better be prepared for an agonizing legislative veto process. I would much rather see Congress decide when to tax fringe benefits and which ones to tax than to attempt to review and modify a stream of regulations from the Treasury Department, especially since it is the constitutional responsibility of Congress. The IRS should not have such powers of taxation and the American people should not be forced to depend on the often inefficient operation of Congressional oversight to protect their interests against the IRS.

The IRS has already targeted several fringe benefits to tax. In an article May 1978, U.S. News & World Report catalogued forty benefits which soon will no longer be tax-exempt, unless Congress takes appropriate action.

Mr. Chairman, I ask that this article from U.S. News & World Report, May 8, 1978, be included in the record of the hearing.

Mr. Chairman, I would like to give you a few more reasons why the IRS should not be allowed to carry out its intentions.

I am concerned that companies and labor unions which must negotiate long-term labor contracts have no clear indication from the Congress as to what portion of fringe benefits will be taxable. The one most affected by this instability is the middle-income wage earner. Any gains he might achieve in contract negotiations may be wiped out if IRS regulations are upheld at some future date. In addition, long-term planning by business is seriously curtailed by uncertainty with regard to future wage and benefit commitments.

Another reason is that many employee benefits are primarily for the convenience of the employer. The Treasury Department has previously ruled that supper money paid to an employee for overtime work is for "the convenience of the employer" (O.D. 514, 2 C. B. 90). Likewise, many other employee benefits should fall within that definition. When an employer provides free parking on his premise for his employees, he does so to facilitate the punctual and orderly ingress and egress of his employees. When an employer provides a subsidized cafeteria for his employees, he may do so for any number of self-interest reasons. The length of the lunch period, the physical proximity to comparable commercial food facilities, or the desire to keep the employees close to the job-site are all reasons why an employer may wish to attract his employees to his cafeteria by subsidizing the food prices. In each of the

above examples, the benefit has inured to the employee, but the underlying purpose is "the convenience of the employer".

In some cases the employee benefits given are "essential to the operation of the business". Many industries, especially those requiring a high degree of technical competence on the part of its employees, provide extensive and continuing on-the-job training. For example, a line crew member for an electric utility company is expected to stay abreast of the latest technical advances in industry hardware. Indeed, it is "essential to the operation of the business" that he be aware of the latest technology so that he may effectively perform his job. Without extensive and continuing on-the-job training, the individual's job performance and his personal safety may be jeopardized. There are many examples of how the employee benefit of on-the-job training is "essential to the operation of the business". Mr. Chairman, should the IRS be allowed to tax the employee for on-the-job training? This is one of the fringe benefits the IRS has targeted.

Mr. Chairman, under the Tax Treatment Extension Act of 1978 (H.R. 9251), Congress prohibited the issuance of any tax regulations on fringe benefits before 1980. Recently activity in both Houses of Congress has extended that preclusion through 1981. I urge prompt action on this bill because it recognizes that it is primarily the responsibility of the Congress to legislate tax policy, therefore precluding the necessity of extensio the Tax Treatment Extension Act.

Let me emphasis that S. 224 s not prevent the taxation of fringe benefits. If the Congress wishes to raise rev es by taxing these benefits, it will still have the authority to do so. S. 224 will en the Congress to maintain direct control over the creation of new taxes at a time when the American people are crying for an end to the increasing tax burden.

Finance

40 Fringe Benefits IRS Wants to Tax

At a potential cost of billions to taxpayers, the government is getting ready to lower the boom on an array of perks for individuals. Look for a battle in Congress.

New rules that would impose taxes on dozens of employe fringe benefits are about to be unveiled by the Internal Revenue Service.

Just about every employe in the country appears to be a potential target. Congress, which would not have to pass on the actions now in the works, can be expected to howl—and maybe even move to thwart IRS plans.

The boxes on these pages indicate how extensive the tax-free perks of executives and other employes are—and how sizable they can be.

Fringes for millions. At least 40 benefits are under scrutiny, and they reflect an astonishing variety. Many perks, such as price discounts allowed for retail clerks, are the privilege of millions of individuals.

Some, such as free tuition for children of college staff members and free or nearly free air travel for families of airline employes, can mean thousands of dollars in tax-free benefits in a year.

While many business executives are enjoying the use of company cars and airplanes, car salesmen are getting full-time use of demonstrator models and millions of other employes are benefiting from subsidized lunchrooms and free parking spaces—all tax-free.

If all these fringe benefits were to be taxed, the added revenues would run into the billions.

The position of the IRS is that, legally, all of these benefits are taxable compensation to employes.

The Internal Revenue Code, officials point out, defines income for tax purposes as "all income from whatever source derived," including compensation for services."

That section, the Supreme Court has ruled, "is broad enough to include in taxable income any economic or financial benefit conferred on the employe as compensation, whatever the form or mode by which it is effected."

Officials point out, however, that there are two kinds of exceptions to that dictum. Many of the most important fringe benefits—pension and profit-sharing programs, group health coverage and the like—are exempted from current taxes by acts of Congress.

In addition, three major perks have been made tax-free by specific rulings or regulations issued by the IRS. These are free or reduced tuition for children of college employes, free or nominal fares for employes of airlines, railroads and bus lines, and reimbursement of supper money for employes when they work overtime.

However, Internal Revenue Commissioner Jerome Kurtz warns that, for those three benefits, "IRS is legally empowered to change these rules to bring them more into line with the law as it has been developed by the courts over the years."

IRS officials are preparing to act on their own, without seeking legislation from Congress.

What to expect. Tax agency lawyers are drawing up proposed new regulations that, if adopted, will tax many fringe benefits for the first time.

How inclusive will the proposed rules be? Commissioner Kurtz answers: "I would hope that we can draft rules including most items."

Not all fringe benefits will come under the tax law, to be sure. Many will specifically be made tax-exempt under carefully spelled out guidelines. Some

In the Tax Collectors' Sights—

Scores of employe fringe benefits go untaxed without any provision for them in law. Now the IRS wants to tax most of them. Here are 40 examples of perks under scrutiny:

1. Price discounts for store clerks.
2. Free trips in the U.S. and, in many cases, abroad for employes of airlines, railroads and bus lines.
3. Free tuition for spouses and children of university faculty members and other employes.
4. Free parking on employers' premises.
5. Overdraft privileges for bank officers and directors, often at low or no interest.
6. "In kind" benefits such as free or cut-rate telephone and power service for retired employes of phone companies and other utilities.
7. Use of company cars by executives and other employes, including use of demonstrators and "executive cars" by salesmen and executives of auto dealerships.
8. Cars and chauffeurs provided for high executives of federal, state and local governments.
9. Travel reimbursement for employes going between home and temporary work sites—say, an accountant driving to or from a client's office.
10. Season tickets to football, baseball and other games, used by employes.
11. Free tickets to the theater and concerts.
12. Christmas gifts—worth more than the $25 exempt by law—from employers.
13. Beach cottages and other vacation facilities maintained by companies for free use by employes.
14. Conferences at resorts for "sales leaders," spouses.
15. Employment-agency fees and expenses of interview trips paid by prospective employers.
16. First-class air travel when first class is not essential to the business of company officers and directors.
17. Rebates to employes who buy their firms' products.
18. Free subscriptions and low-cost gift subscriptions for employes of magazines and other periodicals.
19. Executive use of assistants and other staff members on personal matters.
20. Residences provided free for executives.

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small fringe benefits, for example, will be made exempt because they are not worth trying to tax. Just as the law itself now exempts Christmas gifts valued at $25 or less, the new rules will exempt fringes of strictly nominal value. Reimbursement for an occasional dinner bought by an employe working overtime, for example, might come under that exception.

Some other benefits are to remain tax free because they are too difficult to evaluate. For example, the market value of free parking at a downtown office building is easy to determine, but a space outside a plant miles from any city might be hard to price.

What the IRS is trying to do in writing the landmark regulations on fringes, Commissioner Kurtz says, is "to screen out small, hard-to-handle, difficult-to-value items." But on a vast array of fringes, workers, executives and other recipients may well find themselves liable for tax payments.

Why is the IRS moving to tax fringe benefits that traditionally have been "free"?

"Because," says Kurtz, "basically, fringe benefits are taxable income under the law," and the IRS is bound to enforce that law.

The problem, he explains, is that the law does not spell out the tax treatment for most fringe benefits. As a result, some or all of them are likely to be subjected to taxes in specific cases when they show up in an audit of an individual's tax return.

Tax lawyers and accountants say this means that any individual's tax may depend on which Internal Revenue district he lives in, or on the mood of the agent who audits his return.

Seeking answers. In an effort to get the fringe issue settled, the Treasury in September, 1975, wrote a set of proposed new regulations setting out standards for determining the taxability of fringe benefits. However, recognizing the explosive nature of the issues, officials did not formally propose the new rules but simply published them in the form of a "discussion draft."

The move met such a storm of protest from Congress and elsewhere that the draft was suddenly withdrawn on Dec. 17, 1976, by then Secretary William Simon. He said the blanket approach to the fringe-benefit problem was all wrong.

And Congress, playing for time, wrote legislation forbidding the IRS to issue new fringe-benefit regulations [illegible]. That measure has yet to become law, but the IRS has committed itself to adopt no new regulations on the subject before July 1.

As a result, the IRS is not even issuing any new fringe-benefit rulings to inquiring taxpayers or responding to revenue agents who request advice in cases that are under audit.

But the pledge to defer the actual

How Fringes Can Add Up

Here are the Bosleys, a hypothetical family of five: Jim, a university professor; wife, June, an airline reservations clerk; daughter, Sally, a department-store clerk; twin sons.

The Bosleys live in a large campus house on which the university pays maintenance and utility costs. Tax-free benefit—about $1,000.

Because of their father's position, the sons pay no college tuition. Tax-free benefit—about $8,000.

Each year Jim, June and the boys travel abroad on free airline tickets and pay reduced hotel rates because of June's airline job. Tax-free benefit—about $3,000.

Sally buys all sorts of family items at a substantial discount at her department store. Tax-free benefit—about $750.

Both parents have free parking spaces at their jobs. Tax-free benefit—about $1,000.

The couple frequently enjoys meals and entertains often at the faculty club, paying reduced rates. Tax-free benefit—about $950.

Jim and June use other university facilities—golf course, exercise gym, tennis and squash courts—free or at reduced cost. Tax-free benefit—about $800.

Total annual tax-free benefits: $15,500.

21. Free receptions and entertainment for wives at trade conven[illegible] overseas.
22. Education in the form of free on-the-job training.
23. Loans to employes at low or no interest to buy company stock or for other purposes.
24. Employer's credit cards used by employes to shift [illegible] costs to the firm.
25. Old-age homes provided by companies for their retired employes.
26. Executive memberships in lunch and country clubs.
27. Home improvements for executives that are paid for by employers.
28. Financial counseling and accounting services provided by companies for executives.
29. Employe cafeterias and executive dining rooms offering subsidized prices.
30. Lunch and dinner money provided for employes in all sorts of situations.
31. Deferred pay for executives who each year elect to forgo a specific amount of their salaries and channel it into tax-sheltered investment accounts.
32. Executive trips on company planes to resorts.
33. Annual medical checkups, with [illegible] services.
34. Company picnics, Christmas lunches, parties.
35. Bodyguards for corporate executives.
36. Taxi fares for employes working [illegible] after dark.
37. Tennis, squash courts, swimming pools, other recreational facilities provided by companies for free use by employes.
38. Free bus transportation to plants in distant locations or offices in unsafe neighborhoods.
39. For Americans working overseas, such benefits as education for children, residences, decoration and furnishing of homes, maid and valet services, meals and entertainment at nominal cost at military or government posts.
40. For members of Congress, haircuts, shoeshines, discounts on merchandise, transportation and meal reimbursements, limousines, parking, personal work by secretaries, day-care facilities, picture framing—and one free steamer trunk each session.

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IRS Chief Kurtz wants fringe benefits to be taxed—or specifically exempted.

adoption of new regulations is not being allowed to prevent the IRS from drawing up and proposing such rules for public study and comment. The plan is to issue these in a few weeks.

Washington's silence has not kept revenue agents in the field offices from [illegible] benefits show up on audits of returns. Some of the resulting disputes find their way to the Tax Court. When they do, the IRS usually wins.

Dealer pays up. Take the case of the auto dealer who was ordered to pay taxes on the value of his free use of one of his company's executive cars. Knowing that dealers and their executives all over the country enjoy free use of company cars without any tax liability, the man was outraged. But the court could find nothing in the law or regulations to let him off free.

In another case, the Supreme Court held that cash reimbursement of troopers' expenses for lunch while they are on duty is taxable income, even though tax law says reimbursement for meal expenses on overnight business travel is not counted as income.

Opponents of the IRS position argue that, because Congress has had many years in which to make fringes clearly taxable, the agency is usurping authority in going ahead on its own.

But Commissioner Kurtz insists that the IRS simply wants to get the issue settled—to make fringe benefits clearly taxable or tax free under law.

By proposing new regulations imposing taxes on most such perks, Kurtz hopes to push Congress into writing legislation that spells out clearly the tax treatment of all such benefits.

But with Congress already balking on President Carter's tax-reduction and reform program, the IRS effort may draw nothing from Congress but another "stop" order on taxing employe perks. ☐

Abroad, It's Full Speed Ahead For Most Tax-Free Perks

Unlike the U.S., there is little pressure in foreign countries to end their equivalent of tax-deductible three-martini lunches—or to start taxing other fringe benefits.

However, some changes in perks are being made by corporations. Japanese executives, for example, may double up in company cars instead of riding alone.

But even in Britain, where the Labor government might be expected to trim perks, there is no clamor to do so. One reason: Union chiefs, who are close allies of the government, collect a tidy assortment of fringes.

Says a London civil servant: "Union leaders get low salaries, but they also get London flats, chauffeur-driven cars, and give some of Britain's best and biggest parties."

Only in Canada is there anything like the agitation in the U.S. for a tax crackdown on fringes.

Elsewhere, fringe benefits are considered essential to morale. Taxes on high incomes are often confiscatory, and perks lessen the demand for pay raises.

From a survey by the magazine's international staff:

LONDON

The range of benefits for a British executive is wide and imaginative—from a car and gasoline credit card to a clothing allowance.

Executives receive interest-free loans to pay for their children's private schools. Bargain mortgage rates are available for home loans.

Unless a firm is entertaining foreigners, it has less freedom than in the past for expense-account hospitality. Yet companies pick up the tabs for race-track boxes and hunting privileges, both of which are used with or without foreign guests.

PARIS

Fringe benefits are catching on in a big way here. The reason: Government-imposed ceilings on salaries force companies to find other ways to reward executive talent.

Some companies pay an individual more than one salary. By crediting some payments to a subsidiary abroad, the firm evades France's salary ceiling of $6,200 a month.

There are other nominal perks, such as use of a car and plane, and memberships in clubs. Executives get bonuses for overseas trips.

ROME

Increasingly popular among Italian companies: providing housing for executives. Firms doing this are no longer troubled by employes' reluctance to accept transfers because of high rents in big cities.

An increasing number of firms are giving tax-free annual bonuses in addition to the use of cars, club memberships and expense accounts.

GENEVA

Compared to his counterparts elsewhere in Europe, the Swiss executive is a poor cousin in fringe benefits. Salary counts for more here than expense accounts.

Further, tax authorities scrutinize business expenses carefully. Use of a company car, for instance, would be considered taxable income.

TOKYO

Fringe benefits are so deeply ingrained in Japanese business life that they will probably never be seriously curtailed. Expense accounts alone are expected to cost companies 30 billion dollars this year.

The general rule: A high executive's expense allowance should exceed his pay.

Free cars and housing, the latter even for lower-ranking employes, are common.

A profits squeeze is bringing changes. Executives are giving up their rent-free vacation homes.

BUENOS AIRES

For the Argentine businessman, "black money" is an increasingly popular fringe benefit.

It's cash—paid under the table, not reported to the tax man, free of any deductions. Says one executive: "It is the only way you can get the kind of people you need."

OTTAWA

Innovations in fringe benefits range from paid sabbatical leaves to memberships in health clubs to paid outside financial counseling.

But the government has moved against some lavish perks.

One casualty: Company-owned hunting lodges aren't deductible anymore; firms are closing them.

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U.S. NEWS & WORLD REPORT, May 8, 1978

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Senator BYRD. Incidentally, when the Assistant Secretary of the Treasury was here earlier today and indicated a lack of enthusiasm for this bill, I tried to get from him a listing of just what the Treasury had in mind, but he does not, at this point, have that.

Senator HATCH. Well, this lists at least 40 of the proposals that they have considered.

In addition, Mr. Chairman, Mr. James K. Limona, chairman of the Committee on Fringe Benefit Taxation, North American Interline Clubs Conference, which represents 50,000 members employed by the airline industry in the United States, has submitted a two-page statement dated September 17, 1979, to me, and I would ask that that be placed in the record.

Senator BYRD. That will be placed in the record.

[The material referred to follows:]

NORTH AMERICAN INTERLINE CLUBS CONFERENCE,
COMMITTEE ON FRINGE BENEFIT TAXATION,
Union City, Calif., September 17, 1979.

Senator HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management.

My name is James K. Lamona, and I am representing the North American Interline Clubs Conference (NAICC) and its 50,000 members employed by the airline industry in the United States.

NAICC is in full support of Senate Bill S. 224, as proposed by Senator Orrin Hatch, and urge its prompt passage. We believe passage of this bill will clearly inform the Treasury Department and the Internal Revenue Service that it is Congress which has the duty and authority to legislate tax policy.

The subject of fringe benefit taxation may very well be one which should be addressed. We submit that the issues should not be resolved through administrative fiat by IRS rulings. The very complexity of the subject demands the insight and balance that can only come through congressional debate. A point well understood by Representative J. J. Pickle, chairing the hearings last year for the Task Force on Employee Fringe Benefits, Committee on Ways and Means, when he stated, "what may appear to be a can of worms is apt to turn into a den of rattlesnakes once we get into specific recommendations".

It is obvious to the most casual observer that Congress now has before it too many important issues of vital concern to this nation to spend the time determining how much Congressmen should be taxed for their haircut, the factory worker for their parking spot, the Sears employee for their store discount, or the airline employee for their stand-by ticket home.

Unless Congress reserves their right to make those determinations in the future by passing S. 224, the IRS will attempt to usurp that authority with administrative rulings.

Should the IRS successfully gain that authority, the potential negative impact on business is truly awesome to contemplate. Commissioner Jerome Kurtz has publicized his "laundry list" of fringe benefits to be taxed and it is of sufficient scope to encompass virtually every employed person, and certainly every business in the country, no matter how small. Just the cost of paper work would probably knock out the many "fat cat" fringe benefits like the dishwashers lunch. Of course, that would mean re-negotiating his union contract, and that means raising the cost of food for patrons, and that means raising the Consumer Price Index, etc., etc. It all adds up to non-productive business costs, a questionable increase in tax revenues, and chaos for everyone.

Naturally, as airline employees, the immediate concern of NAICC is the tax treatment of free and reduced rate transportation. The taxing of this "fringe benefit" is one high on Commissioner Kurtz's list. IRS rulings since 1921 have held this benefit to be non-taxable and the use of "free" employee travel has been instrumental in building the highest quality privately owned public transportation system in the world.

The "free" travel has been the incentive necessary for airline employees to endure the rigors and expense of "space available" travel for the past 58 years. Every journey undertaken has been a learning experience for the employee involved. That personal knowledge of peoples, places, and things has then been made available to the traveling public and increased their willingness to try the same

experience. Both the public and the employer have gained the services of a highly qualified staff, and the industry has prospered to the point where it now provides employment for over 500,000 individuals.

Tax this fringe benefit and you remove the incentive to learn. Alernatives would have to be found to provide that experience, and the upheavel of that search could easily destroy the air travel industry as we know it today.

The potential for such disruption should not be allowed to rest in the hands of an IRS Commissioner.

Senate Bill S. 224 has no effect on tax receipts, it merely maintains the status quo. If the Congress wishes to tax these benefits in the future it will still have the authority to do so. In the meantime it will allow the legislature to maintain direct control over the creation of new taxes at a time when the American people are crying for an end to the increasing tax burden.

We appreciate this opportunity to express our views in support of S. 224.

Sincerely,

JAMES K. LAMONA, *Chairman.*

Senator HATCH. Well, I thank my two colleagues and I certainly appreciate appearing before this very distinguished committee.

Senator BYRD. We are pleased to have you and I think the record should show that the Treasury Department is opposed to this legislation.

Senator HATCH. If you will excuse me, Mr. Chairman, I have to run.

Senator BYRD. Senator Chafee?

Senator CHAFEE. Mr. Chairman, I just had one question.

Do I understand—first, we are grateful that Senator Hatch personally came here and I have had an opportunity to discuss this with him personally. I know he has given it a lot of time and thought.

Do I understand that this S. 224 would prevent Treasury forever—in other words, there is no time limit. The present law expires January 1, 1980. Yours is not just a deferral; it is a prohibition against the Treasury.

Senator HATCH. Right. That is correct. Because what the IRS is trying to do is just go off and legislate tax policy which is our obligation and our responsibility and frankly, if we wanted to tax fringe benefits, then the Congress ought to tax them and ought to set the limits and parameters to which they want taxes to apply.

And if we just allow the IRS to go out and legislate, then I think we are wrong, and that is the purpose of this legislation.

Senator CHAFEE. Of course, the difficulty is in determining where you draw the line. In other words, if you provide a house for an employee, under the law, currently, there are regulations. There are regulations that determine whether that house is necessary for the business purposes of the corporation and so forth, or whether it is not, and then whether it is taxable.

But then when you get to giving a discount to an airline employee's family to travel to Hawaii at space available paying 10 percent, or whatever it is, then that gets more difficult.

Senator HATCH. I think that is a good point, but there is nothing in my bill, which is a very simple bill, which would prohibit the IRS, once we set the legislative parameters, to determine regulations pertaining thereto, and I think that they can go ahead and do that.

It is just in this particular case, if you look at the list of the 40 fringe benefits that they were planning on taxing, or at least would like to tax, it goes into many, many legislative areas—in fact, all

40 of them are, in my opinion, legislative areas that would be better for the Congress to set, than for the Internal Revenue Service.

Senator CHAFEE. But—I am not arguing with your point, but for instance, in your view, would Congress take up and discuss when a cafeteria meal provided at discount is a fringe benefit and when it is not? Would we get into each of these specifics? Is that the way you would approach it?

When is a country club dues payment a fringe benefit and when is it not?

Senator HATCH. I think Congress can determine if it wants to, the specific areas, but I would presume that Congress would have to enact general legislation that would apply in certain fringe benefit areas. It has already done that in the Internal Revenue Code and we already have legislation that defines certain fringe benefits that are taxable and for which the IRS can establish regulations.

But what I want to prevent is this ad hoc, wholesale usurpation of congressional initiatives by an administrative agency for its own purpose even though in the past it has not deigned to do so.

Senator CHAFEE. Well, we thank you very much for coming, Senator.

Thank you, Mr. Chairman.

Senator HATCH. I thank both members of this committee.

Senator BYRD. Thank you.

Senator HATCH. If you will excuse me?

Senator BYRD. We appreciate your being here.

Mr. Bodfish, I think you commented earlier in the day.

Mr. BODFISH. Yes, sir.

Senator BYRD. Do you want to make a few remarks?

Mr. BODFISH. Yes, sir, if I may.

Mr. Chairman, Senator Chafee, if I may introduce my colleague Mat Kennedy who is tax counsel for Shell Oil and is appearing here today as the senior vice president of the Tax Executives Institute.

STATEMENT OF JAMES M. BODFISH, PRESIDENT, TAX EXECUTIVES INSTITUTE, ACCOMPANIED BY W. DALE HAY, CHAIRMAN, SUBCOMMITTEE ON FRINGE BENEFITS, AND MAT KENNEDY, SENIOR VICE PRESIDENT, TAX EXECUTIVES INSTITUTE

Mr. BODFISH. Let me just begin by saying I think there are two aspects of this problem, one being what is a fringe benefit and compensation and that which is a fringe benefit and which is not taxable under our tax system; and secondly, if it is a fringe benefit and compensation, what is the method of evaluation to be determined?

The institute is concerned that adoption of S. 224 will not be the permanent solution to what is, and what is not, taxable compensation includable in the employee's gross income. The problem of taxability of fringe benefits is one which has perplexed the American taxpayer, the American businessman and the Internal Revenue Service for many years.

In order to insure the integrity, simplicity, and uniformity of the tax system to facilitate compliance and to provide certainty to businessmen as to the consequence of their actions, clear and reasonable guidelines should be enacted by the Congress.

It would appear to the institute that Senate bill 224 generally, and broadly, exempts from taxation those currently known items generally recognized as fringe benefits, but does not establish clear guidelines to identify other facilities, goods, or services, which may be excluded from gross income.

The institute recommends the following approach to the taxation of fringe benefits. The following fringe benefits would not be taxed:

Fringe benefits which are currently excluded from income under specific provisions of the law should continue to be exempt.

Two, any fringe benefit which is basically a working condition should not constitute taxable income, such as, office space, furniture, fixtures and similar items; employee-provided parking space; supper money and transportation for overtime in an amount equal to the actual amount expended, or reasonable standard amount set by the employer; subsidized cafeterias and restaurants; de minimis gifts and periodical social functions, such as picnics, Christmas parties, and so forth, but substantial awards, such as holiday trips, should continue to be taxable.

Three, employee merchandise or service discounts. These should not be taxable if available to a reasonably broad class of employees.

Four, use of employer facilities where such facilities otherwise have a bona fide business purpose. It should not be taxable if available to a reasonably broad class of employees. If not available to a reasonably broad class of employees, not taxable unless the employer incurs a measurable additional cost other than de minimis costs.

In the case of taxable fringe benefits, the measure should be the incremental cost incurred by the employer or other persons supplying the benefit. De minimis additional costs should be disregarded.

This recommendation is made for two reasons. First, as pointed out by Assistant Treasury Secretary Donald Lubick in his testimony on August 1, 1978, there is some concern as to whether any person would pay the so-called fair market value to obtain most fringe benefits.

Second, by using a measure based upon incremental employer cost, the effect of fringe benefits on the tax system is neutral. That is, the employer will receive a deduction equal to the amount included in the employee's income as in the case of cash salary and wage payments.

There are other recommendations which are included in our statement. I ask that that statement be made a part of the record.

Senator BYRD. That will be made a part of the record.

[The prepared statement of Mr. Bodfish follows:]

Statement Of
James M. Bodfish, President
On Behalf Of
Tax Executives Institute, Inc.,
Washington, D. C.
On S. 224
A Bill to Prohibit Permanently the Issuance of
Regulations on the Taxation of Fringe Benefits
Before The
Subcommittee on Taxation and Debt Management
Senate Finance Committee
September 17, 1979

Mr. Chairman and members of the Subcommittee: I appear before you today in my capacity as President of the Tax Executives Institute.

Tax Executives Institute, Inc., (TEI) is an organization with approximately 3,250 individual members representing 1,800 of the largest corporations in the United States and Canada. Membership in TEI consists of persons employed by corporations and other businesses who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

Tax Executives Institute, Inc., is dedicated to the principle that administration of and compliance with the tax laws in accordance with the highest standards of professional competence and integrity in an atmosphere of mutual trust and confidence between business managements and tax administrators promotes uniform enforcement of taxes and minimization of the cost of administration and compliance to the benefit of both government and taxpayer.

One of the stated purposes of TEI is "To cooperate with Government tax administrators in meeting and solving problems of tax administration."

TEI appreciates this opportunity to submit its position and comments on S. 224, a Bill to prohibit permanently the issuance of regulations on the taxation of fringe benefits.

SUMMARY

Tax Executives Institute is concerned that adoption of S.224 would not be the permanent solution to what is, and to what is not, taxable compensation includable in the employee's gross income. The problem of taxability of fringe benefits is one which has perplexed the American taxpayer, the American businessman and the Internal Revenue Service for many years. In order to insure the integrity, simplicity and uniformity of the tax system, to facilitate compliance and to provide certainty to businessmen as to the consequence of their actions, clear and reasonable guidelines should be enacted by the Congress.

It would appear to the Tax Executives Institute that S.224 generally and broadly exempts from taxation those currently known items generally recognized as fringe benefits but does not establish clear guidelines to identify other facilities, goods or services which may be excluded from gross income. Thus, the American

taxpayer, the American businessman and the Internal Revenue Service will continue to face uncertainty and differences of opinion as to the taxability of numerous items.

PROPOSED SOLUTION

The Institute previously recommended the following approach to the taxation of fringe benefits:

A. Fringe Benefits Which Should Not Be Taxed

1. Fringe benefits which are currently excluded from income under specific provisions of law should continue to be exempt.

2. Any fringe benefit which is basically a working condition should not constitute taxable income, e.g.

   a. Office space, furniture, fixtures and similar items

   b. Employer provided parking space

   c. Chauffeur driven automobiles for executives or government officials to enable such individuals to work while traveling even if such traveling is between the employee's residence and his place of business

   d. Free or subsidized transportation for employees where safety or availability is the primary factor

   e. Supper money and transportation for overtime in an amount equal to the actual amount expended or a reasonable standard amount set by the employer

   f. Availability of goods or services to the employee for testing and/or evaluation purposes

   g. Subsidized cafeterias or restaurants

   h. Security costs such as burglar alarms or the furnishing of bodyguards where the need for such items is reasonable under the circumstances

   i. Travel agents' familiarization trips

   j. De minimis gifts and periodic social functions such as picnics, Christmas parties, etc. (but substantial awards such as holiday trips should continue to be taxable)

3. Employee Merchandise or Service Discounts

   These should not be taxable if available to a reasonably broad class of employees.

4. Use of Employer Facilities Where Such Facilities Otherwise Have a Bona Fide Business Purpose

   a. Not taxable if available to a reasonably broad class of employees

   b. If not available to a reasonably broad class of employees, not taxable unless the employer incurs measurable additional costs other than de minimis costs

B. Measurement of Fringe Benefits for Inclusion in Income

In the case of taxable fringe benefits, the measure should be the incremental cost incurred by the employer or other person supplying the benefit. De minimis additional costs should be disregarded. This recommendation is made for two reasons. First, as pointed out by Assistant Treasury Secretary Donald Lubick, in his testimony on August 14, 1978, there is some concern as to whether any person would pay the so-called fair market value to obtain most fringe benefits. Second, by using a measure based upon incremental employer costs, the effect of fringe benefits on the tax system is neutral. That is, the employer will receive a deduction equal to the amount included in the employee's income as in the case of cash salary and wage payments.

C. Other Recommendations

Because of their nature and the difficulty in many cases of accumulating the necessary data, we believe that even where fringe benefits are taxable, they should not be subject to the withholding tax on wages but instead be subject to the requirements of information reporting, i.e., Forms W2 and 1099.

Furthermore, we believe that even where fringe benefits are subject to the income tax, they should not be subject to the Federal Insurance Contribution Act (FICA) and the Federal Unemployment Tax Act (FUTA). We make this latter recommendation because where fringe benefits effect highly salaried employees, such employees normally would have income in excess of the limit of contribution for the above taxes. With respect to lower paid employees, the additional complications and administrative work are considerable and would involve costs which are excessive in relation to the amount of additional tax involved.

For the same reasons, we feel that where meals and lodging are excluded from income under Sec. 119 of the Internal Revenue Code, such meals and lodging should be excluded from the provisions of FICA and FUTA.

Conclusion

Although adoption of S.224 would appear to reduce the uncertainty associated with the taxation of some fringe benefits, it is not in our professional judgment the full and final solution to the problem. The prohibition against the issuance of regulations in the taxation of fringe benefits will add to the uncertainty and cause the lack of uniformity in the enforcement of the tax laws.

Respectfully submitted,

James M. Bodfish

James M. Bodfish
President
Tax Executives Institute

Senator BYRD. Thank you.
Mr. Murdoch?
Mr. MURDOCH. Mr. Chairman, I appreciate being a witness here today, and I have submitted a written statement which I will ask to be included in the record.
Senator BYRD. That will be included in the record.

STATEMENT OF CONVERSE MURDOCH, PRESIDENT, SMALL BUSINESS COUNCIL OF AMERICA

Mr. MURDOCH. Small businesses have a particular interest in this matter of taxation of fringe benefits because small businesses, unlike big businesses, do not have the access to inside counsel, inside accountants, and inside computer services, which enable them to comply with the regulations about the taxation of the great miscellany of fringe benefits.

Small business supports this legislation, because we would like this subject to be covered at hearings such as this where we can have an input on particular proposals and explain how they would affect small business.

Before coming here, I was intrigued to pick up Newsweek for this week. It has on the cover a picture of a very macho guy on a horse and it says, "The Angry West; Get Off Our Backs, Uncle Sam."

I have aspirations that I will be on the cover some day and the headline will be "Angry Small Business; Get Off Our Backs, Uncle Sam." That is our plea. Get off our backs.

My wife tells me that even if I moved to Utah, got the same tailor as this guy and got a horse, I probably would not make the cover, but I do want to report, Senator, that small business people are upset by the ever-increasing regulations to which we are subjected.

I have one specific proposal with regard to this legislation. I urge the subcommittee to consider including in this legislation—if it is not already included—a deferral of any change on self-insured medical expense reimbursement plans. That was a matter which was taken up in the closing days of the last Congress, in the last session, and was inserted in the 1978 Revenue Act at the last minute without, what I would consider adequate consideration by Congress. I urge that this committee extend this legislation to self-insured medical expense reimbursement plans.

The new rules on self-insured medical expense plans are going to become effective January 1, 1980, unless they are deferred. I urge the subcommittee to put that topic in with the other fringe benefits provisions and that Congress act on them when Congress feels it is ready to act on all of these items.

Thank you, Mr. Chairman.
Senator BYRD. Thank you, Mr. Murdoch.
Senator Dole?
Senator DOLE. I have no questions.
Senator BYRD. Thank you, gentlemen.
[The prepared statement of Mr. Murdoch follows:]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

FINANCE COMMITTEE

Statement Submitted by Converse Murdoch, Esq.
At Hearings on S. 224

September 17, 1979

This statement is submitted in connection with the Subcommittee's consideration of the parts of the bill having to do with deferral of the effective dates of any new regulations with respect to income taxation of various employer-sponsored fringe benefit programs.

This statement is submitted by me on behalf of the Small Business Council of America, Inc.

I am an attorney in private practice in Wilmington, Delaware. Most of the clients of our firm are owners and principals in small businesses - mostly closely held.

I am also the President of the Small Business Council of America, Inc.

Summary of Statement

The following is a summary of my statement.

I urge the Subcommittee to recommend that changes in the law or regulations having to do with income taxation of employer-sponsored fringe benefit programs be deferred for at least one year until the Congress has had an opportunity to thoroughly consider the ramifications of any changes with respect to the income taxation of benefits supplied under employer-sponsored fringe benefit programs.

I urge that in connection with this deferral to give the Congress adequate time to consider the matter, the Subcommittee recommend that S. 224 be expanded to include a deferral of the effective date of § 105(h) of the Internal Revenue Code of 1954, as enacted by § 366 of the Revenue Act of 1978.

The cited section was enacted during the closing stages of Congressional consideration of the Revenue Act of 1978 and without hearings before the Finance Committee.

The cited section is not yet effective. It is destined to become effective January 1, 1980, unless Congress defers this effective date in order to give adequate time for Congressional consideration of the matter.

Section 366 of the Revenue Act of 1978 for the first time introduced into the income tax law a concept of non-discrimination for employee benefits which requires absolute dollar equality of promised benefits for covered employees, regardless of the compensation of the various employees. It requires that in a self-insured medical expense reimbursement plan unless there is absolute dollar equality of promised benefits, the employer-sponsored medical expense reimbursement plans will become disqualified and result in inclusion in taxable income of benefits furnished to officers and highly compensated employees.

Small Business Has a Particular Concern With Respect to Taxation of Fringe Benefits

All businesses (and many employers not operated for profit) are concerned by the administrative hassle factor which will be aggravated by changing

the rules with respect to taxation of employer-furnished fringe benefit programs, including employer-sponsored self-insured medical expense reimbursement plans.

Small business has a particular concern with respect to these matters because it can ill afford the legal, accounting and administrative burdens imposed by these ever-changing rules. Many small businesses are not able to cope with the problems posed by these rules. They cannot afford the computer services which are available to larger businesses which attempt to comply with the withholding and social security tax obligations of the employer and employees.

Small businesses particularly feel overwhelmed by the paper work burdens which seem to increase daily. As a result, more and more owners of small businesses are simply throwing up their hands and abandoning worthwhile fringe benefit programs, rather than subjecting themselves to the hassle and expense associated with these ever-changing rules and regulations.

Accordingly, the Small Business Council of America urges the Subcommittee to postpone the effective date of any new rules with respect to fringe benefit programs, including self-insured medical expense reimbursement plans.

Within a matter of a few weeks, self-insured medical expense reimbursement plans will have to be curtailed, terminated or drastically changed to comply with § 105(h) of the Internal Revenue Code. It's not too late for the Congress to postpone this effective date and have medical expense reimbursement plans

considered along with all other fringe benefit programs, with a view to establishing sensible and workable rules with respect to the income taxation of such programs.

Background of Income Taxation of
Self-Insured Medical Expense Reimbursement Plans

Prior to the enactment of the Revenue Act of 1978, it had become commonplace for most employers to maintain some sort of a program under which the employer paid all or part of the costs of employees' medical care. These plans did not fall into any clear-cut categories. The variety of these plans were almost literally infinite. The health care needs of particular individuals are so varied that it was a practical impossibility to devise one, two or even ten standard plans which met the particular needs of an individual employee or a group of employees. The size of the employee-group, the age and sex makeup of the group, the geographical location of the group and hundreds of other factors influence the design of employer-sponsored health care plans.

For purposes of certain health care benefit programs, many employers (particularly those in the small business community) found that self-insurance was both feasible and economical.

The growth of these plans was encouraged by the provision in the Internal Revenue Code permitting exclusion of such employer-furnished benefits from the taxable incomes of the benefitted employees.(1) The principal requirement of the Internal Revenue Code prior to the Revenue Act of 1978, with respect to tax qualification of employer-sponsored health care plans was that the plans be for the benefit of employees as opposed to benefitting

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(1) See particularly § 105 of the Internal Revenue Code.

stockholders. The Internal Revenue Service was successful through litigation in denying income tax exclusions with respect to plans which were patently discriminatory in favor of the owners of a business, as opposed to the non-owner employees.(2)

These plans flourished in no small part due to the fact that there was a minimum of administrative burden on the sponsoring employer. One has only to look at what happened to many small, qualified pension plans after the imposition of the regulatory burdens imposed by ERISA to appreciate why employers were willing to establish, continue and expand health care programs. In the case of the latter, there was a minimum of "hassle" factor in terms of forms to be completed and filed with the Internal Revenue Service and others.

The Revenue Act of 1978

Early in 1978, the Administration, as part of its proposals to the Ways and Means Committee, recommended that anti-discrimination rules somewhat similar to those found in the pension and profit sharing plan area be imposed on employer-sponsored health care and other welfare benefit programs.

After hearings on this proposal, the Ways and Means Committee rejected the Administration proposal in this regard. It

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(2) See Leidy et al, 34 TCM 1476, 1975 P-H TC Memo ¶ 75,340 (1975) aff'd per curiam 77-1 USTC ¶ 9144, 39 AFTR 2d 77-877 (4th Cir. 12/16/76); John H. Kennedy, Inc. et al., 36 TCM 878, 1977 P-H TC Memo ¶ 77, 210 (7/11/77) and cases cited there.

was generally assumed among the taxpayers familiar with this matter that the rejection of these proposals by the Ways and Means Committee spelled the end of the proposal - at least in connection with the bill which eventually became the Revenue Act of 1978.

However, with no public hearings or prior discussions, at the last minute during consideration of the Revenue Act of 1978, the Senate Finance Committee recommended the enactment of § 366 of the Act. In essence, that section imposed on self-insured medical expense reimbursement plans drastic and novel anti-discrimination rules.

The section, as it cleared the Finance Committee, proposed that any self-insured medical expense reimbursement plan which provided greater benefits for stockholder-employees, officers and highly compensated employees than were provided for other employees would be deemed discriminatory and, as a result, the members of the prohibited group would be required to include in taxable income the excess of benefits received by them over the benefits provided for other employees. It's important to note here the substantial and drastic difference between the anti-discrimination rules of § 366 of the Revenue Act of 1978 and anti-discrimination rules which for years had been applicable in the pension and profit sharing plan area. In the pension and profit plan area, it has long been recognized that a plan is not discriminatory merely because benefits are proportionate to other compenation. However, in § 366 of the 1978 Act, for the first time discrimination was tested in terms of absolute dollars of

benefits, rather than in terms of percentage of compensation.

It's also important to note at this point that § 366 of the 1978 Act is limited to self-insured plans. The effect of this is that a self-insured plan which is discriminatory for purposes of that Act can acquire a tax-favored status by the simple device of having an insurance company provide the benefits. The effect of this is merely to cause the employer to incur the extra costs associated with the purchase of insurance. The effect will not be to spread benefits to more employees. The only ones who will profit from this rule will be the insurance companies who can now charge employers a fee for providing benefits which heretofore the employers were able to provide more economically on their own.

As all members of Congress are aware, the Revenue Act of 1978 was passed during the final days of the session. As a result, there was little opportunity for the tax-paying public to become aware of § 366 of the 1978 Act - much less to study it and make comments to members of Congress.

The Technical Problems

Because of the infinite variety of employer-self-insured plans, it's a practical impossibility for anyone at this time to point up all of the technical problems which will be encountered once § 366 of the 1978 Act becomes fully effective. The only way that even a substantial fraction of these problems can be brought to the surface and considered is through hearings on the substantive provisions.

An ideal and practical way for these problems to be considered and dealt with is to repeal § 366 of the 1978 Act so that this subject can be considered in connection with the Congressional study of the entire fringe benefit area. This will permit the appropriate Committees of the Congress to also reconsider these matters before the new provisions become effective.

Technical Problems Under § 366 of the 1978 Act

There are myriad technical problems posed by § 366 of the 1978 Act.

Attached to this statement is an Appendix, listing in summary form, a few of the technical problems which have been posed by the enactment of § 366 of the 1978 Act. No claim is made that this list is anything more than the result of scratching the surface of the problems. When Treasury Regulations are proposed and public comment is invited, there will undoubtedly be many other problems which will surface and have to be dealt with.

Until more problems have surfaced and can be dealt with, it is a great unfairness to employees covered by self-insured medical expense reimbursement plans to keep them in doubt as to whether their plan qualifies under § 366.

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As long as there is doubt about these matters, the natural reaction of employers will be to drop plans unless and until there is clarification. This would be a most unfortunate development benefitting no one. There would be no appreciable revenue effects flowing from such a development. The Joint Committee Staff general explanation of the Revenue Act of 1978 says on this point:

> "This provision [§ 366 of the 1978 Act] will have no revenue effect in fiscal year 1979 and will increase budget receipts by less than $5,000,000 per year thereafter. [Emphasis supplied]."

By way of a sampling of the technical problems which will have to be resolved in regulations, the following can be mentioned:

1. Is it permissible to have a plan under which the employer reimburses employees for premiums for various kinds of health care insurance where the amount of premiums reimbursed varies with the cash compensation of the employees?

2. Does the provision apply to government programs?

3. What benefits are part of the "plan"? For example, assume that an employer maintains what is concededly a non-discriminatory plan and during the last part of a plan year, as an act of compassion for a member of the prohibited group, the employer reimburses him for some catastrophic expense. Does this mean that on a retroactive basis the plan becomes non-qualified?

4. How does one test discrimination in favor of the highest paid 25% of employees when there are less than four employees? Are all of the employees in such a situation in the top 25% or are none of them?

These are real problems. Unless and until they are solved in the Regulations, employers will be given no practical alternative to either incurring the additional cost of paying an insurance company to run the plan or simply abandoning the plan.

Conclusion

I respectfully urge that if the Subcommittee is not prepared at this time to recommend the repeal of § 366 of the Revenue Act of 1978, that it at least change the effective date so that it is not applicable until taxable years beginning after the Congress has had an adequate opportunity to consider the entire fringe benefit area.

APPENDIX TO STATEMENT OF
CONVERSE MURDOCH
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

September 17, 1979

Samples of Technical Problems Under
Section 366 of the Revenue Act of 1978

1. Will employers be required to submit information returns reporting taxable benefits? The original legislation is silent regarding the employment tax and withholding duties under section 366. The Conference Report says there is no social security tax or withholding associated with the provision. Under section 103(a)(10)(A) of the Technical Corrections Act of 1979, payments excludable under section 105 of the Code will be free of withholding. No mention is there made of social security taxes. As drafted, the provision of the bill says nothing about payments which are not excluded under Code section 105 - i.e., benefits made taxable by virtue of section 366 of the 1978 Act.
2. Will government plans for government employees be covered?
3. What will constitute "insurance"? For example, can a single employer or a small group of employers own the insurance company which provides the benefits? What if premiums for "insurance" are tied directly to the benefits paid?

4. In attempting to comply with sex anti-discrimination rules, can an employer end up violating section 366 of the 1978 Act? For example - what if the members of the prohibited group are women and the other employees are men and the plan pays maternity benefits?
5. How will the rules be applied when an employer has an interest in a second (or third) business in another locale where certain medical care benefits are not feasible?
6. How can one determine whether a particular employee is one of the highest paid 25% when there are less than four employees?
7. May the employer reimburse all employees for health care insurance premiums based on levels of compensation? Is such a plan "self-insured"?
8. Will Treasury go along with Conference Committee definitions of part time and seasonal employees?
9. Under a plan which requires three years of service - what breaks in service will require the commencement of a new three year employment period?
10. Does making an employee an officer late in the plan year retroactively disqualify the plan?
11. What is the definition of an "officer"? For example, is a clerical employee designated an Assistant Treasurer solely to enable that person to sign state unemployment tax return forms an "officer"?
12. Will the Treasury agree with (and can it effectively <u>and fairly</u> administer) the suggestion in the Conference Committee Report

that plans should not be retroactively disqualified if "the plan has made reasonable efforts to comply with tax discrimination rules"?

13. Will the Treasury agree that section 366 as written permits integration with plans of other employers?

14. How will "plan" be defined in the Regulations? Assume a clearly non-discriminatory written plan and late in the year the employer, without amending the plan, pays substantial hospital bills for the terminally ill wife of a junior executive. Is such a payment part of the plan and therefore is the whole plan retroactively disqualified?

[Note these are but samples of the problems. Every day more problems surface. When the section becomes fully effective, the flood of problems will accelerate.]

Senator BYRD. The next piece of legislation to be considered will be S. 616. There will be a panel consisting of Dr. Henry Clausen, sovereign grand commander, the Supreme Council, Washington, D.C.; Mr. Charles J. Claypool, imperial potentate of the Shrine of North America, accompanied by Mr. Edward G. Magg; and Mr. Robert S. McIntyre, public citizen, Tax Reform Research Group of Washington, D.C.

Welcome, gentlemen. I am particularly glad to see my friend, Henry Clausen, here this morning.

Mr. CLAUSEN. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, I have filed a statement with numerous exhibits which I ask be filed with the committee and therefore I will save time by not reading the statement, but I would like to skim over portions.

Senator BYRD. Yes. Your statement will be published in full in the record.

STATEMENT OF HENRY CLAUSEN, SOVEREIGN GRAND COMMANDER, THE SUPREME COUNCIL, WASHINGTON, D.C.

Mr. CLAUSEN. My name is Henry C. Clausen. I am now, and have been since 1969, the sovereign grand commander of the Supreme Council, Southern Jurisdiction. Prior to that, my masonic experience has been as master of my own lodge in San Francisco and as grand master of the grand lodge in California.

The total membership of the southern jurisdiction, or mother jurisdiction, is 650,000 with local organizations in some 220 cities throughout the United States.

In addition to speaking for my organization, I, this morning, speak for the northern masonic jurisdiction at the request of the sovereign grand commander, Stanley Maxwell. They have a total combined membership of 500,000 so I am speaking for some 1,175,000 men.

The membership of the Scottish Rite is derived from Master Masons who received three degrees in a what we call symbolic lodge, and that is governed by the various grand lodges of each of the States. It is restricted to men of good character, good morals, good reputation, belief in God, immortality of the human soul, subject to unanimous favorable ballot.

Those number today about 3.5 million in the United States and the problem arises, which is behind this legislation, that the meeting places of these masonic lodges and of the Scottish Rite, in many cases, have become dilapidated, are in unsafe places of cities, requiring removal, renovations, improvements, and rehabilitation.

The subject of rehabilitation might seem sort of odd when it is borne in mind that these combined masonic organizations today, and every day, contribute toward charity more than $1 million, but those funds are earmarked for charitable purposes. They may not be touched to do the renovating, may not be touched to do the fixing and the improving required, in order to maintain membership.

The result is, Mr. Chairman and committee, that the membership is in an acute situation with regard to need for these renovations, and therefore, we point out that the organization itself is

solely and exclusively educational, charitable, and religious, and that the Congress already has so found.

In other words, the Congress has found in the legislation 501(c)(10) that the organization must, in order to qualify for an exemption, possess the qualifications that I have set forth on the sheet here, which I also would ask to be filed, which gives the legislative history in part and, Mr. Chairman, distinguishes the masonic organizations from other nonprofit organizations.

It says in the legislative history—this was the joint committee of the Congress—believes that it is appropriate to provide a separate, exempt category for those fraternal beneficiary associations—such as the Masons—that is the Congress paren—which does not provide insurance for their members, and that is us.

Senator BYRD. Without objection, that document will be inserted in the record, Mr. Clausen.

[The material referred to follows:]

The legislative history of Section 501(c)(10) of the Tax Reform Law of 1969 shows that the Congress recognized and found our special situation and consequent rights. It reads in part:

"A new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations."

The Congress further recognized and found our Supreme Council House of the Temple at Washington, D.C. entitled to real estate tax exemption. This was Private Act 92-23 of the 92d Congress, H.R. 7718, August 13, 1971.

Mr. CLAUSEN. And I would point out that in order to receive that exemption you naturally must qualify under that section, and that does not, however, include only the Masons. There are included, I know, Knights of Columbus, Odd Fellows, Elks, Sons of Italy, Knights of Pythias, and similar other organizations who, of course, would speak for themselves.

So we ask that the committee favorably report the legislation 616.

Senator BYRD. Thank you, sir.

Mr. Claypool?

STATEMENT OF CHARLES J. CLAYPOOL, IMPERIAL POTENTATE OF THE SHRINE OF NORTH AMERICA, ACCOMPANIED BY ED MAGG, GENERAL COUNSEL

Mr. CLAYPOOL. Mr. Chairman, I am Charles J. Claypool, the imperial potentate of the Shrine of North America, and I have with me our general counsel, Ed Magg, from Illinois.

I represent approximately 1 million Shriners across the country, and every Shriner must be a Mason. I have been traveling every week to the various parts of the country and I have observed in many cities the condition of our Masonic buildings and, as my brother said, some of them are pretty old.

I would say the average age of our Masonic buildings in the United States is over 50 years old.

But the Shrine itself, being a part of Masonry, this year will spend over $50 million taking care of crippled and burned children. We receive no aid from the Federal Government, or any State

government, and we do not even take money from the insurance company.

We have raised this money ourselves, and we are mighty proud of it, and we operate 21 hospitals absolutely free and no one has ever received a bill since 1922. Nineteen of these hospitals are located in the United States, and no one has ever received a bill.

I want to speak on behalf of our 942,000 members that we support this bill wholeheartedly, and if you would, I would ask my general counsel if he has a statement.

Mr. MAGG. Thank you.

My name is Edward G. Magg. I am an attorney at law. I am general counsel for Shriners Hospital for Crippled Children and the Shrine of North America, the fraternity.

I wish to say that our fraternity sponsors, and wholly supports, alone and through our friends, what has been known as the world's greatest philanthropy. There is not anything like our philanthropy anywhere on earth, sponsored by anybody, because we treat, and have treated, over 200,000 crippled and burned children, restored them to active, normal lives, and we have never accepted any money. We do all of this without regard to race, color, or creed.

Now, the reason our philanthropy is so universally accepted and so successful is that we have the support of 170,081 temples, the individual Shrine fraternal temples. Without those temples supporting our philanthropy, the philanthropy could not exist.

In every temple when we say that we spend $50 million a year, that is just on patient care. That does not include all the money spent by the individual temples inside their own temple buildings for publicity, fundraising, patient recruitment, patient transportation, for transportation of the parents of patients to our 21 hospitals.

None of that money is included in the $50 million that we spend directly for patient care.

I remind you 5 years ago the Internal Revenue Service audited our philanthropy extensively. It was of great interest to the agents to find that our philanthropy produced more money and operated at a less percentage administrative costs than any other philanthropy that they have ever audited in history. Less than 1 percent of our total revenues are devoted to administrative costs.

We are most efficient. We are proud of what we do and we believe that the fraternity and the philanthropy are intertwined; one would not exist without the other.

We believe this bill is reasonable. We believe that we need it in order to support our philanthropic endeavors.

Senator DOLE. Do you feel the legislation would help your organization carry out its charitable functions?

Mr. CLAYPOOL. Senator Dole, as I stated earlier, our membership of 942,000 members are all Masons. We have shown a constant growth as far as the Shrine is concerned, but our well is going to run dry if we do not help our Masonic brethren across the country because they have lost over 330,000 members in the last 5 years.

Mr. CLAUSEN. Senator Dole, may I also concur, and point out that our statement in this regard is not based upon conjecture but real experience that has shown that where you remove a local lodge in some town to a more secure place, or where you just fix

the kitchen up and put in new carpet and paint the place, you attract members and if you do not do that, you lose members. If you do not do that, you kill the goose that laid the golden egg because the members supply the funds for the philanthropic purposes.

Mr. MAGG. I would respectfully suggest that the hundreds of millions of dollars raised annually by the fraternity devoted to charitable purposes are raised by the fraternity devoted to charitable purposes, which otherwise the burden of which would have to be borne by government agencies, or others.

So I respectfully suggest that we do perform a great public service and there is a substantial public interest in this bill.

Senator DOLE. I am informed by the staff that the estimated cost of the bill is $5 million. Are you having trouble raising money for charitable purposes?

Mr. CLAUSEN. It is diminishing, Senator Dole. As membership diminishes, our ability to raise funds diminishes. So if, for example, as is the case, you have a loss in the total combined Masonic membership of 50,000-plus a year and you extend that back 10 years, then in the future 10 years, you are certainly going to lose the capacity to carry out these charitable functions.

That is why I say you are killing the goose who laid the golden egg. You can take the charity without helping the charity to produce.

Senator DOLE. Obviously, the problem is whether it is an internal activity or charitable activity and how you distinguish.

Should there be any tax preference in a case of this type of activity? It is something we are going to have to come to grips within the committee, hopefully this year.

I appreciate your testimony, and your statements will be made a part of the record as if given in full.

Thank you very much.

Mr. CLAUSEN. May I point out further, as I stated, in the pie that is an exhibit to my statement, the amounts contributed by these organizations exceeds $1 million a day, so if there was an impact study by any Treasury Department of the figure that you mentioned, Senator Dole, it would be negligible in comparison to the charities expended.

Senator DOLE. Thank you.

Mr. CLAUSEN. Thank you.

Senator DOLE. Mr. McIntyre?

STATEMENT OF ROBERT S. McINTYRE, PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP, WASHINGTON, D.C.

Mr. McINTYRE. Thank you, Senator Dole. It is appropriate that you are here, since three of the four bills to which we have objection have your name on them, and maybe we can discuss them and indicate our objections.

Senator DOLE. If you could do it in 5 minutes?

Mr. McINTYRE. First of all, I'd like to discuss the fringe benefits bill, S. 224. We think that this bill is the wrong approach to the fringe benefits problem and really reflects, as has been indicated in statements that some of the sponsors have made, a misunderstand-

ing of exactly what the current law is and what the current situation is.

The current law, section 61 of the Internal Revenue Code, requires that all compensation including most of these in kind benefits be included in income unless there is a statutory exception. Commissioner Kurtz has only proposed that he enforce the law, which has not been done very well in the past. To leave the Revenue agents out there running wild, without any regulations, without any guidance for them, or for that matter for taxpayers, seems to us to be a terrible mistake.

Now, it was discussed this morning with Secretary Lubick, why can we not wait until Congress approves some legislation that clarifies the area? The problem is we have been waiting for congressional clarification for some time. Ways and Means had a task force on the issue and put out a very good report, but Ways and Means was unable to act on it this year. They put it off again to a nonelection year, 1981. I am afraid that process will continue for a very long time, and we will continue to have taxpayers in one district being treated differently than taxpayers in another, with tax results depending on the whim of a Revenue agent or on the happenstance of being audited.

I think the prohibition on proposed regulations would be a mistake for the Congress to enact, and that a short-term extension, if the Congress wants to, will be much more appropriate. That is why the Ways and Means Committee has passed something like that.

The second bill I want to comment briefly on deals with the independent contractors issue. We are opposed to S. 736 for a number of reasons. The first of which, is that we do not think the standards in the bill make much more conceptual sense than do the current common law standards, as applied to the withholding issue.

The issue here, of course, is trying to make sure that the taxes are collected. There is no ironclad rule from heaven that says you have to withhold from employees, either. It is just a convenient way of insuring that the taxes are paid. It's convenient for employees as well, because they are paying a little bit at a time, rather than having to file quarterly estimated tax returns or pay in one lump sum in April.

We think the focus of any new rule in this area, whether in trying to redefine "independent contractor" or deciding when withholding should be required, ought to be on the real issue: Is it convenient and feasible to require some kind of withholding? Because we know, from studies or from anybody's personal experience, when there is withholding, compliance goes up.

In addition, other areas are affected. Social security benefits are affected; so is eligibility for pension plans. But just looking at the income tax compliance issue, it seems clear that we ought to focus on convenience and feasibility.

I do not think S. 736 really does that. It seems to have been designed merely to respond to the complaints of the people that have been affected by the recently intensified IRS audit program. There is also a problem in S. 736 in that it is so broad.

Let me give you some examples of some of the people who could be treated as independent contractors under the bill: Most of the

high-level Federal bureaucrats on flex time under the new incentive program could be treated as independent contractors. U.S. Senators could be treated as independent contractors. Most of the associates in law firms downtown, now treated as employees, could switch to independent contractor status.

It is not necessarily that it would lead to abuses, in every area, but it certainly would apply in the odd situations. And abuses would likely result in some cases. We have an example in our testimony of an employer would like to set up a tax-free pension plan for himself, but cannot do it, because he would have to include his employees.

Rather easily, under your bill, he could switch them to independent contractor status, and exclude them from the pension plan. Those are the kinds of problems that we have with S. 736. We have endorsed the Treasury's withholding approach.

Senator DOLE. If you took care of that problem, you would be for the bill?

Mr. MCINTYRE. No. I do not think it makes sense, in any case.

Senator DOLE. You would rather have a whole lot of horror stories?

Mr. MCINTYRE. We have several problems, not just one.

We have endorsed the Treasury's withholding approach. We think it could reduce some of the tensions in the area. A few years down the road, we might be able to look at the definitional question a little harder, and figure out where we are to go on that.

Finally, we are opposed to S. 616, which would give a tax deduction to the Masons for their building funds. We are opposed because these buildings are not used exclusively for the kinds of purposes that a tax deduction would be approprate for, any more than a building of my organization, which is a 501(c)(4) would be appropriate for a charitable deduction.

Senator, could I put in the record in connection with the discussion of fringe benefits our suggestions to the Ways and Means Task Force on Fringe Benefits?

Senator DOLE. Is that a lengthy document?

Mr. MCINTYRE. No.

Senator DOLE. That will be made a part of the record.

[The material referred to follows:]

August 15, 1978

STATEMENT OF PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP
TO
THE WAYS AND MEANS TASK FORCE ON EMPLOYEE FRINGE BENEFITS

This statement is submitted by Public Citizen's Tax Reform Research Group in response to the Task Force's August 3, 1978 request for brief position papers on the taxation of fringe benefits. We have followed the outline suggested by the Task Force in formulating our comments, and we hope to provide more detailed testimony at a later date.

(1) Specific concerns:

Our specific concerns are that the tax system attain to the maximum degree possible:

(a) fairness among taxpayers,
(b) progressivity in tax burdens,
(c) economic neutrality, except in unusual circumstances,
(d) simplicity and comprehensibility,
(e) ease of administration, and,
(f) by a combination of the above factors, the respect and voluntary compliance of taxpayers.

With regard to the taxation of employee fringe benefits, the application of these criteria leads us to the conclusion that all such benefits should be included in taxable income, except for certain benefits whose proliferation the Congress strongly wants to encourage, and then only if safeguards are established to assure that high-income employees are not benefitted to the exclusion of rank and file workers. One additional general exception we would favor is a *de minimus* rule, sparingly applied. We offer some administration suggestions for the application of such a rule below.

(2) Areas of present law involving the greatest uncertainty:

The legislative and regulatory status of fringe benefits is — at least on paper —

remarkably clear. Section 61 of the Internal Revenue Code provides that "gross income means all income from whatever source derived, including (but not limited to) . . . (1) compensation for services . . . [and] (2) gross income derived from business." The IRS regulations under this section are even more explicit: "Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accomodations, stock, or other property." The purpose and policy behind such an expansive definition of income are clear: A tax system which exempted in-kind compensation would be whimsical and capricious, treating similarly situated taxpayers radically differently, depending upon their mode of compensation. And taxpayers with sufficient ingenuity could arrange their affairs to decimate or even totally avoid their tax liabilities.

The only exceptions to the general rule that fringe benefits are part of taxable income are those specifically provided for elsewhere in the code. For example, employer-supplied health insurance, qualified pension plans, and group term life insurance are tax-exempt; but employer-paid vacations, personal use of company cars, and stock options are clearly taxable.

The hardest issues in the public mind seem to arise in the area of employee discounts on employer-produced or -sold items: such things as "courtesy discounts" on merchandise, free plane rides for airline employees, free tickets for theatre personnel, and so forth. Although these items clearly represent additional compensation, there is some reluctance on the part of the public to see them as taxable, and some disagreement over the proper valuation of the items. We support Commissioner Kurtz's position that the proper resolution of the tax status of these kinds of benefits should be consistent with the treatment given to the same benefits provided by other employers. Many of these fringes would be excluded from taxation under a *de minimus* rule like the one we suggest below. For larger items — in the rare cases where past public uncertainty seems at least somewhat justified — we suggest prospective application of "new" rules.

(3) Statistical evidence:

As the Task Force knows, the data on the quantity and scope of fringe benefits is still very sketchy. We would like to refer the Task Force, however, to a study performed last year by Hays & Associates of Philadelphia, which surveyed 368 companies and found that executive fringes averaged $10,000 each for $30,000 employees, and $30,000 each for $100,000 employees.

(4) Recommendations:

The actual administration of the rules on fringe benefits has unfortunately not

enjoyed the clarity of the statute and regulations. In part, this has been due to the fact that, until recently, IRS concentrated on the individual taxpayers who failed to report the income, rather than on employers who failed to withhold on it. In any event, whether individuals have actually paid taxes on their fringe benefits has largely depended upon particular taxpayers' personal integrity and their understanding of the law or on the happenstance of an IRS audit. When the Service has gone to court it has almost invariably won, but many taxpayers continue to flaunt the law on the assumption that detection is unlikely and that, by pleading ignorance, they can avoid serious penalty if they are caught. (Of course, many other, more scrupulous taxpayers do report their fringe benefits accurately. A notable example is President Carter, who paid taxes on $3,000 worth of free plane rides for his family in 1977.)

We believe that the solution to the fringe benefit problem lies mainly with the IRS and the Treasury. Issuance of comprehensive regulations, including numerous examples, would go far toward clarifying the situation in the public mind. Vigorous enforcement of the withholding laws would encourage compliance without creating untoward sudden burdens on employees. This Task Force could make IRS's job much easier by offering an endorsement of such an approach.

There is one area in which a legislative solution might be advisable. Although the Service applies an *ad hoc de minimus* rule in deciding which fringe benefits to go after, the "rule" is now of varying and uncertain application — a fact which justifiably leads to taxpayer resentment. This Task Force might consider recommending a statutory *de minimus* rule for the Service to apply. One possible approach might be to allow an annual aggregate exclusion of $100 worth of fringes before an employer begins withholding or reporting on the benefits, and an additional $100 deduction for employees from any reported fringes. This would mean, in effect, that $200 worth of fringes per employee per year would be tax-exempt — a figure large enough to exempt most people, but small enough to avoid serious unfairness.

On the other hand, we believe that a statutory *de minimus* rule on a *per item* basis is inadvisable, since it will only set the parameters for abuse (e.g., the china set given one piece at a time). In practice, however, IRS will probably apply a per item *de minimus* rule as an adjunct to the $100 exclusion.

Thank you for this opportunity to submit our suggestions.

Robert S. McIntyre
Staff Attorney

Senator DOLE. Thank you very much.
[The prepared statements of the preceding panel follow:]

STATEMENT OF PROPOSED TESTIMONY OF HENRY C. CLAUSEN
SOVEREIGN GRAND COMMANDER OF THE SCOTTISH RITE
MOTHER JURISDICTION

PRELIMINARY

We support the legislation currently before the Congress which would allow tax deductions for contributions to maintain or build facilities of organizations already exempt from income taxes under Section 501(c)(10) Internal Revenue Code.

The current legislation is S616 that Senators Dole and Thurmond sponsored and HR4175 that Representative Duncan sponsored.

We support this on the grounds -

1) Facilities of these organizations in many cases have become dilapidated or need removal to a more secure section of a city thus giving the members incentive for membership increase and interest. Experience has shown that renovations, improvements and rehabilitation results in membership maintenance and increase and thus generating funds for the charitable objectives for the organizations.

2) Funds for these purposes in many cases are not available to the organizations and would be contributed as tax deductible.

3) Membership increase and interest is vital because the organizations are the said source of combined Masonic philanthropies in the United States. They exceed more than one million dollars a day. If the Masonic base is diminished or destroyed, the Government necessarily will be forced to pay those amounts and this would far exceed the tax benefits from passage of the legislation.

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4) The proposed legislation would apply and accrue to all similar non-profit organizations to all races, colors and creeds.

FACTS

My name is Henry C. Clausen. I am and have been since 1969, Sovereign Grand Commander of the Supreme Council, Mother Jurisdiction. My experience Masonically has been, in addition and prior thereto, Master of my Lodge and Grand Master of the Grand Lodge of California with services on related committees. My official functions include supervision of my organization's operations.

Our total membership is about 650,000 with local organizations in some 220 cities throughout the United States and the total membership of the Northern Masonic Jurisdiction, the only other Scottish Rite Organization in the United States, is about 550,000, or a total of combined United States membership of one million, one-hundred and seventy-five thousand.

The Supreme Council (Mother Council of the World) of the Inspectors General Knights Commanders of the House of the Temple of Solomon of the Thirty-third Degree of the Ancient and Accepted Scottish Rite of Freemasonry of the Southern Jurisdiction of the United States of America is a nonprofit organization, and comprises thirty-five statewide organizations and overseas areas under United States control, each nonprofit. No part of the net earnings of these organizations inures to the benefit of any individual.

The Supreme Council was organized at Charleston, South Carolina in 1801, and from it are descended all regular and recognized Scottish Rite organizations in the world.

The Supreme Council later was incorporated by Act of Congress on March 13, 1896, and its headquarters presently are located at the House of the Temple, Washington, D.C.,

This national organization governs the activities of all its subordinate bodies in over 35 states and all United States territories and military bases. It is supported by fees and dues from the subordinate bodies, by proceeds of the sale of its books, by investments, and by legacies. Its governing statutes and laws require that the organization be nonprofit and charitable, religious and educational.

The subordinate Bodies, known as Valleys, comprise four separate Bodies, i.e., the Lodge of Perfection, the Chapter of Rose Croix, the Council of Kadosh, and the Consistory. As a follow-up of the charters, each of the Bodies, as provided by statute, enact bylaws, after approval by the Sovereign Grand Inspector General and The Supreme Council.

Membership in the Scottish Rite Bodies is restricted to Master Masons, i.e., recipients of the first three Degrees in a Symbolic Lodge, which is governed by the Grand Lodges and in which membership, as is also true in the case of Scottish Rite, is restricted to men of good morals, good character, good reputation, belief in God and in the immortality of the human soul, and subject to unanimous favorable vote.

One of the primary functions of the four Bodies in a Valley, in addition to the religious and educational aspects, is the charitable contributions. The Lodge of Perfection confers degrees from the 4th to the 14th. The Chapter of Rose Croix confers degrees from the 15th to the 18th. The Council of Kadosh confers the degrees from the 19th to the 30th. The Consistory confers the degrees from the 31st to the 32nd. The Supreme Council confers the 33rd degree.

Each Body is separate, elects its own officers and candidates, and confers its own degrees. The Lodge of Perfection, and a nonprofit temple corporation, are constituted the fiscal and title holding agents.

The Masonic organization of which the Scottish Rite is a part is solely and only and

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exclusively educational, charitable and religious. The three categories are the only functions; it has no other function, no other work.

In 1927 The Supreme Council contributed one million dollars to The George Washington University in Washington, D.C. to endow a School of Government. Since then the Scottish Rite support has sustained a continuing Scottish Rite Fellowship Program. Over 500 students in the Schools of Government, International Affairs and Business have benefited from this program.

During the last nine years a special Public School Administration Scholarship has helped qualified applicants attain a doctor's degree in Public School Administration. Many Subordinate Bodies of the Scottish Rite have followed the example of the Supreme Council and make available scholarship funds to advance education focused on the living freedoms we as Americans enjoy.

Among the many charitable and philanthropic efforts of the Rite are our impressive efforts in behalf of children. In 1915 the Scottish Rite Hospital for crippled children, located in Atlanta, Georgia has offered hope and remedy to thousands of victims of birth defects and childhood illnesses and crippled conditions. The statistics alone are impressive. The $5 million facility has 50 beds, operates 32 out-patient clinics, performs, on the average, 3,500 operations each year and treats 12,000 patients annually.

Similarly, the even larger new Texas Scottish Rite Hospital for Crippled Children in Dallas, Texas, with a 125-bed capacity, has replaced, at a cost of $30 million, an outdated facility started in 1921. Since that date, 35,000 children have been treated, and today, with the new building, even better treatment is possible with the center's up-to-date therapy, research and patient care capability.

A second major thrust of the Scottish Rite's many philanthropic efforts is care of the aphasic child. Childhood aphasia, a nerve-related malfunction, affects the learning and

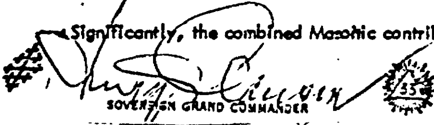
language capacities of children of normal intelligence. Modern research has revealed means of eliminating or minimizing this tragic condition, and since 1958, the Scottish Rite Consistories in Denver founded a philanthropy to bring speech to brain-injured children. Later, about 18 years ago, the California Scottish Rite created and established the Scottish Rite Institute of Childhood Aphasia under the direction of Dr. Jon Eisenson at Stanford University. In 1973 the facility, staff and Dr. Eisenson moved to San Francisco State University. The program was so successful that it was expanded to other Valleys in California and to Florida, Kansas, Mississippi, North Carolina, Tennessee, Virginia, Oklahoma, Texas, Nebraska and Georgia. Today, the Rite supports aphasia clinics which test, treat, refer or cure children with these disorders. Specialized professional therapists are employed with local volunteers so that this significant program combines the best of dedicated grassroots support with expert central medical treatment at the Scottish Rite Institute.

The Supreme Council made the following contributions over the years as indicated on the attached memo. See also the attached related exhibits.

Benevolence and charity are inherent in Freemasonry and have been since time immemorial. The organization is charitable. It is not organized or operated for profit or for the financial benefit of any member or individual, except as may be disbursed by way of charity or relief. A subordinate Valley acts as a collector or money-gatherer for The Supreme Council, which carries out lthe major plan of dispensing relief.

A member of The Supreme Council and of each subordinate Valley is appointed Almoner whose function is to disburse to local needy people moneys collected from the members. This is done without regard to religion, without regard to membership in the Order, without regard to race, creed or color.

Significantly, the combined Masonic contributions to charities in the United States exceeds one million dollars a day!



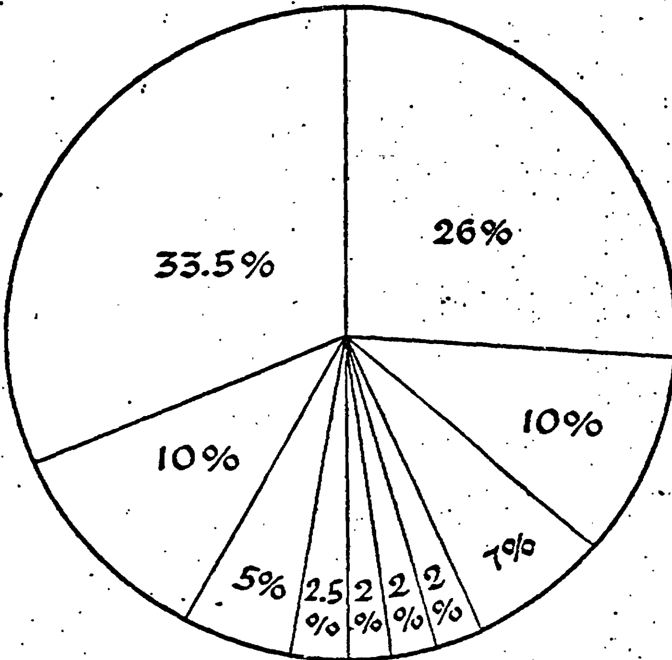
CHARITABLE, EDUCATIONAL OR RELIGIOUS CONTRIBUTIONS

April 6, 1979

American Humanics Foundation, Kansas City, Mo.	1960	$ 1,500
American Red Cross	1954-68	8,700
American University	1958-65	70,000
Baptist Theological Seminary		10,000
Baylor University	1957-79	95,000
Boys' Club of Metropolitan Police	1954-79	7,175
Care	1954-59	5,000
Children's Hospital, D.C.	1959-78	6,100
Central American Relief	1965	2,500
Colorado Flood Relief	1951	2,000
Community Chest	1954	1,000
Council of Churches, Nat'l. Cap. Area	1959-62	1,800
Doan College	1965-71	30,000
Florence Crittendon Home	1968-79	1,000
Frank S. Land College of Education	1975	1,000
Freedoms Foundation of Valley Forge	1963-79	33,000
George Mason University	1977	2,500
Healing Prayer Fellowship	1975-79	3,000
Hiram Scott College	1969-70	10,000
Horace Mann League of the U.S.A.	1963-67	18,500
Institute of Logopedics in Wichita, Kansas	1965-68	6,000
Kansas Disaster Fund (Tornado)	1966	5,000

Lee Lockwood Library and Museum	1967-71	7,500
Louisiana Hurricane Relief	1957	1,000
Maryland Bible Society	1954-59	7,000
MacArthur Memorial Foundation	1964-71	8,500
Mississippi Hurricane Relief	1969	5,000
National Florence Crittendon Mission	1954-57	10,000
National Multiple Sclerosis Society	1954-78	1,100
New Orleans Baptist Theological Seminary	1964	10,000
Omaha Nebraska Home for Boys	1961-63	2,000
Pusan Children's Charity Hospital	1955-63	7,000
Salvation Army	1977-78	400
Scholarships - Public School Administration Two $5,000 Scholarships each year for doctorates in Public School Administration	1966-78	283,750
School of the Ozarks	1965-69	10,000
Sibley Hospital	1961	800
Silliman University (The Philippines)	1961-63	2,500
Stanford University	1965-74	55,000
The George Washington University Establishment of School of Government, Business and International Affairs	1927-79	1,035,000
The George Washington University - since 1956 420 Fellowship Grants, totalling (approx.)		1,686,800
Luther Rice Society, George Washington Un. Fund	1971-75	6,000
Uta Halee Protestant Home	1961-72	3,500
University of the Pacific	1961-75	55,000
University of Tampa	1966	5,000
Vanderbilt University - Law School Scholarship Fund	1965-66	93,500
Washington Cathedral	1965	5,000
West Central 4-H Educational Center, VA	1967-70	22,500
Foundation for Economic Education	1964-79	475
		$3,645,100

Masonic Charitable Contributions 1975



33.5% - Local "Lodge" Benevolences (50 States), $150,000,000

26% - Masonic Homes and Hospitals, $113,670,000

10% - Masonic Scholarship Programs, $44,800,000

10% - Shrine Hospitals for Crippled and Burned Children, $42,3000,000

7% - Masonic Health Research Projects, $29,410,000

5% - Sundry Masonic Benevolent Programs, $22,770,000

2.5% - National Public Service Projects, $11,450,000

2% - Masonic Relief, $7,215,000

2% - Masonic Youth Projects and Eye Foundation, $5,2000,000

2% - Scottish Rite Masonic Museum and Library, $7,680,000

SCOTTISH RITE HOSPITALS FOR CRIPPLED CHILDREN

NORTH ATLANTA, GEORGIA

THE Scottish Rite Hospital for Crippled Children at North Atlanta, Georgia, the first children's hospital in the world sponsored by Scottish Rite Masons, has since 1915 been the hope and sanctuary for tens of thousands of victims of birth defects and illness. No child is ever turned away because of the inability to pay. Now located in its modern new 50-bed, 5 million dollar facility, the hospital offers 32 outpatient clinics, including the only aphasia clinic in Georgia. 12,000 patients per year come to these clinics for every kind of childhood problem. 3,500 operations per year are performed in the hospital's five operating rooms, the majority to correct spinal curvatures and back deformities.

Having relocated from outmoded quarters in Decatur in July, 1976, the new Scottish Rite Hospital is half again as large as the old and contains semi-private rooms instead of wards, a large recovery room, an intensive care unit, physical therapy gym, complete support facilities and a 200-seat auditorium.

As a teaching hospital it offers post-graduate programs in orthopedics, anesthesiology, and pediatric dentistry. Through its affiliations with medical colleges and institutions it provides specialized instruction for graduate, medical and nursing students.

HE WHO BENDS DOWN TO HELP LITTLE CHILDREN RAISES HIMSELF AND LIFTS THEM TO FAITH AND CONFIDENCE.

DALLAS, TEXAS

THE new Texas Scottish Rite Hospital for Crippled Children, located at 2222 Welborn Street, Dallas, Texas, will be dedicated on January 26, 1978.

At 260,000 gross square feet, the new facility is more than three times the size of the old Hospital, erected by Texas Masons in 1921 when they saw a need for providing medical care for children who were disabled and whose parents could not afford the cost of treatment.

The Hospital is comprised of six levels — two below grade and four above. The basement level contains all supply and logistics support departments. The garden level, one level below grade, is the primary patient entrance and houses clinics, diagnostic support and dining facilities. A glass-enclosed atrium serves as a point of orientation and as the major lobby-seating area, as well as providing a transparent link between the two building masses.

The first level, at grade, houses the visitors' entrance and administrative activities, child development center, and surgical and diagnostic facilities. A 200-seat scientific lecture hall is connected to the main structure at this level. Levels two through four house administration, physical and occupational therapy, research and patient care facilities.

The new facility, with a 125-bed capacity, will enable the Hospital to continue to treat an increasing number of crippled children with the most up-to-date equipment and procedures.

Undertaking of the $30 million expansion project was made possible by a major income producing gift to the Hospital in 1964 by Senator William A. and Villa Blakley. The former U. S. Senator from Texas, a long-time member of the Hospital Board of Trustees and a member of the Building Committee, had oftentimes expressed his enthusiasm for enlarging the facilities for treatment of crippled children in Texas.

More than 35,000 children have been treated at Texas Scottish Rite Hospital in the years since its founding in 1921 until the opening of the new facility. Many of them have been able to lead happy and useful lives, instead of wasted lives that might have been ordained by deformities, and all because of the generosity of people who have cared, particularly the Scottish Rite Masons.

SCOTTISH RITE FOUNDATIONS

CALIFORNIA

IN 1958, the California Scottish Rite Foundation established a program for the training of children with severe language delay in the School of Medicine at Stanford University. The Program was designated as the Scottish Rite Institute for Childhood Aphasia. The Director of the Program, Dr. Jon Eisenson, who is internationally recognized as an authority on language disorders and particularly on childhood aphasia, was able to secure supplemental federal funds to expand the clinical functions of the Institute along lines of basic research in child language and language delay. On the retirement of Dr. Eisenson from Stanford in September, 1973, the Scottish Rite Institute moved to San Francisco State University. At the same time an auxiliary clinical service was initiated at the Scottish Rite Temple in San Francisco.

More than 3,500 children and their families have been given help in the clinics — presently supported by the Scottish Rite. This represents a total of more than 125,000 hours of specialized professional services, including a major amount of nonpaid volunteer help. In addition, these Centers have provided highly valuable consultive and in-service training for aproximately 25,000 professional workers in education, psychology, speech and language pathology, social work, medicine and related fields.

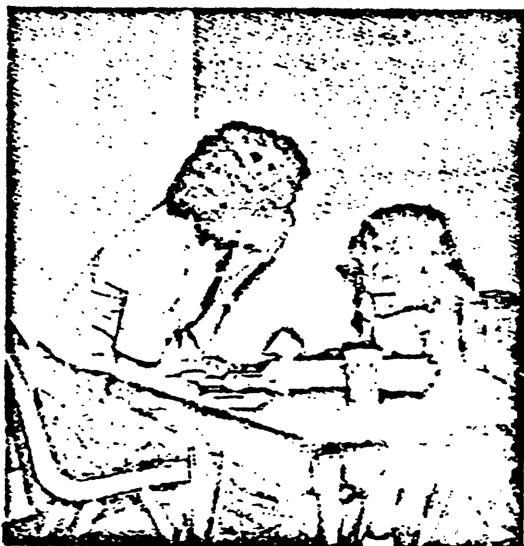
Expansion of the Scottish Rite programs was begun in 1969 in California through the establishment of additional centers utilizing Scottish Rite Temple facilities in other Valleys throughout California.

One of the best of these Temple facilities is located in Los Angeles, an intimate action scene from which is presented herewith. The work in these Temples provides greatly needed diagnostic and consultative services and special remedial help for children from the ages of four to sixteen years who, despite average or general intelligence, suffer from specific learning and language

disorders. These conditions include difficulties in learning to speak (childhood aphasia), in learning to read (dyslexia), and in coordinating finer movements (dyspraxia).

The treatment programs include prescriptive remedial teaching based on a selected sensory approach, either on an individual basis or in small groups of four to six children with similar conditions. In addition to this specialized remedial educational help, many cases require child and parent counseling, remedial exercises and occasionally medications to help improve ability to concentrate or reduce distractibility. Additional consultative help is available as required for each child's classroom teacher and family physician. Advanced in-service training for teachers and other professional personnel is also provided.

As stated by the Sovereign Grand Commander, Ill.·. Henry C. Clausen, 33°, still further expansions of this program are underway throughout the Southern Jurisdiction.



PATIENT LEARNING

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COLORADO

IN 1952, the two Scottish Rite Consistories in Denver founded a philanthropy to bring speech to brain-injured children. Since then, the Southern Colorado and Grand Junction Valleys have joined to form the Scottish Rite Foundation of Colorado so that the Orient, some 18,000 strong, is presently supporting the aphasia program — TO HELP A CHILD SPEAK.

These afflicted girls and boys, usually between the ages of two and eight, are treated through the nationally recognized personnel and facilities of The Children's Hospital of Denver. Treatment runs from one to several years. The miracle of speech has been brought to 1,000 children by the devotion of speech therapists and the benevolent support of the brethren and the people of Colorado. Many patients have succeeded to the extent of completing successfully college degrees or operating their own businesses.

Every Scottish Rite Mason in the Orient contributes at least $2.50 yearly to the program. This is supplemented by endowment income, life memberships, and bequests so that these formerly doomed children can live happy, normal and productive lives.

More and more of our other Orients are activating similar modern programs with marked success. Examples are to be found in California, Florida, Kansas, Mississippi, North Carolina, Tennessee, Virginia, Oklahoma and Nebraska. Alaska makes a contribution each year to further the program.

WRITTEN STATEMENT OF
THE IMPERIAL COUNCIL A.A.O.N.M.S.
TAMPA, FLORIDA
ON
SENATE BILL 616

BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY
COMMITTEE ON FINANCE

U. S. SENATE 96th CONGRESS FIRST SESSION

SEPTEMBER 17, 1979

Identification of individuals who have principal responsibilities in the administration of Shriners Hospitals for Crippled Children:

CHARLES J. CLAYPOOL
Imperial Potentate
Imperial Council A.A.O.N.M.S.
4130 Linden Avenue
Dayton, Ohio 45432

EDWARD G. MAAG
General Counsel
Imperial Council
A.A.O.N.M.S.
4343 West Main Street
Belleville, Illinois 62223

Administrative Offices:

IMPERIAL COUNCIL A.A.O.N.M.S.
Suite 206, Memorial Building
5700 Memorial Highway
Tampa, Florida 33609
(813) 885-2575

STATEMENT

My name is Charles J. Claypool, I am Imperial Potentate for the Imperial Council of the Ancient Arabic Order of the Nobles of the Mystic Shrine for North America, commonly referred to as the Imperial Council A.A.O.N.M.S., a non-profit and tax exempt fraternal organization described under Section 501(c)(10) of the Internal Revenue Code. I have with me our General Counsel, Edward G. Maag.

There are approximately one million (1,000,000) Shriners, the vast majority of whom are Americans. Since 1935, the Imperial Council A.A.O.N.M.S. and its one hundred eighty-one (181) Shrine Temples, chartered by the Imperial Council, have been granted a group tax exempt status by the Internal Revenue Service. the Objects and purposes of the Imperial Council A.A.O.N.M.S. reflect such attitudes as faith in God, man's relationship with his brother and philanthropy.

The Shrine has long been characterized for the color and pageantry of its parades, its marching Uniformed Units, its bands and its clowns. It has been equally characterized for its fund raising activities (circuses and sporting events) which individual Shrine Temples sponsor to raise funds for what many persons have aptly described as "The World's Greatest Philanthropy" -- Shriners Hospitals for Crippled Children.

Every Shriner is annually assessed a hospital assessment by the Shrine to support its charitable endeavor. In addition, whenever our Shrine Units parade, they attempt to call attention to our philanthropy. Our fund raising events are known throughout this great land as a means by which monies are raised to continue this suppo-t of our charity. These monies also substantially assist our Shrine Temples in defraying the expenses of bringing many crippled and burned children, along with their parents, to our twenty-one (21) hospitals for treatment since the charter and regulations of Shriners Hospitals does not permit such expenditure of funds. Likewise, our Shrine Temples meet certain charitable hospitalization needs and expenses of our patients which sometimes goes beyond orthopedic and burn care.

We proudly believe that it has been vividly demonstrated over the years that the Imperial Council A.A.O.N.M.S., or the "Shrine" as it is more commonly known, is a body of men with a dedicated charitable purpose; a purpose for which Shriners freely donate of their time, energy and money.

Since 1922, the Shrine has provided totally free care to children afflicted with orthopedic problems. Over this period of time, about one-fourth (1/4) of the orthopedists in the nation have been Shrine-trained. In 1962, after the military leaders of this nation interested the Shrine in what they felt was one of the greatest unmet needs -- the care and treatment of badly

burned children, we dedicated three (3) hospitals completely to the care of severe thermal injuries in children. The present annual operating expense of Shriners Hospitals for Crippled Children is approximately fifty million dollars ($50,000,000.00). These hospitals have cured or materially helped more than two hundred thousand (200,000) children.

All of these worthwhile fraternal activities sponsored by the Shrine in the interest of public welfare would be greatly imperiled and impeded if the Shrine and other charitable-minded fraternal organizations are not permitted to have donors receive a charitable contribution deduction for gifts and contributions they make to the cost or maintenance of exempt fraternal organization buildings, the principal purpose of which is to house such organization's fraternal and charitable activities. We believe that the revenue lost to the Government for allowing such a charitable contribution deduction to donors must be considered extremely nominal.

On behalf of our one million (1,000,000) Shrine members, we wish to wholeheartedly support the enactment of Senate Bill 616 so that all of our charitable activities can continue through the voluntary assistance of Shriners.

Thank you for giving us this opportunity to testify.

Statement of ROBERT S. McINTYRE
Director, PUBLIC CITIZEN'S TAX REFORM RESEARCH GROUP
Before the Subcommittee on Taxation and Debt Management
Of the Senate Committee on Finance
Concerning S. 224, S. 616, S. 736, and S. 1514
September 17, 1979

S. 224. Permanent Prohibition of Consistent Administration of the Tax Laws with regard to Fringe Benefits.

This bill would permanently prohibit the IRS from establishing a consistent enforcement policy for its agents and clear guidelines for taxpayers with regard to the tax treatment of non-cash compensation received by employees. We are strongly opposed to this measure.

There seems to be a belief on the part of many members of Congress that IRS Commissioner Kurtz is threatening to usurp congressional authority and place enormous new tax burdens on the American people by taxing forms of compensation which heretofore have always been tax exempt. This belief is erroneous. In fact, as was noted in an article inserted in the Record last year by Senator Hatch, the chief sponsor of S. 224, "the tax code is so clear on the taxability of most fringe benefits that the IRS freely admits that its own spotty record of enforcement is largely to blame for its failure to collect." Commissioner Kurtz's proposals to improve enforcement and to rationalize the rules for inclusion of particular items in income are in direct fulfillment of his sworn duty to carry out the laws as passed by Congress. Failure to do so would be the usurpation of congressional authority.

If Congress wishes to exempt certain kinds of compensation from taxation – say, free plane rides for airline employees, merchandise discounts for retail clerks, or vacation facilities for corporate executives – it should move forthrightly to do so. Although we believe that such policy choices would be inequitable and unwise, such an approach would at least be administrable. But to tell the IRS to enforce the laws on fringe benefits on a catch-as-catch-can basis according to the whims of revenue agents and the happenstance of an audit is ridiculous.

The House Ways and Means Committee has just approved a bill providing that no fringe benefits regulations can become effective prior to July 1, 1981. This lengthy continued postponement was designed to push the issue again into a non-election year, and was necessitated by the Committee's failure to take constructive action during the current session on the report of its fringe benefits task force. We believe this Subcommittee should show more courage, and should extend the postponement only to the middle of next year, with an accompanying request to Ways and Means to hold hearings in early 1980. At worst, the Subcommittee should follow Ways and Means' lead and extend the postponement until 1981.

S. 616. Tax Deductions for Building Fund Contributions to Masonic Lodges and Certain Other Fraternal Organizations.

This bill would allow a tax deduction for gifts to fraternal organizations tax-exempt under IRC Section 501(c)(10)* if the funds are used for construction or maintenance of buildings housing such organizations. The primary beneficiaries would apparently be members of Masonic lodges,** which constitute about 90% of the 501(c)(10) organizations.

Individual contributions to Masonic lodges are already tax deductible under IRC Section 170(c)(4), so long as the donations are earmarked "exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals." Masonic lodge *buildings*, however, are utilized only in part for a group's charitable purposes. Other functions usually carried out in the lodge building include entertainment, planning parades, and fellowship meetings.*** Thus, under current law, contributions to a lodge's building or maintenance fund are not tax deductible, and the IRS so ruled in 1956. *Rev. Rul. 56-329.*

S. 616 would reverse this ruling so as to allow deductibility. We believe this result would be seriously inconsistent with the accepted rationales for the deductibility of charitable gifts, and we urge that the bill be rejected.

When the charitable deduction was first established in 1917, its stated purpose was to provide a non-intrusive government subsidy to organizations performing functions that served the public good – functions that the government itself might have to supply if the charitable organizations did not exist.**** Some tax theorists assert in additional support of the deduction that funds (or property) transferred to charities do not constitute either personal consumption or savings on the part of the donor, and therefore should not be part of the *income* tax base under the most common theoretical definition of income. The non-religious charitable deduction has therefore been generally limited to contributions used "exclusively for charitable, scientific, literary, or educational purposes,

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* IRC Section 501(c)(10) applies to "Domestic fraternal societies, orders, or associations, operating under the lodge system –

"(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

"(B) which do not provide for the payment of life, sick, accident, or other benefits."

** Masonic lodges are associations of [illegible] males, dedicated to the improvement of morals and character through fellowship, mutual helpfulness, and symbolic rituals. *See, e.g.*, Blackmer, The Lodge and Craft (1976), p.11, 15; Hammond, What Masonry Means (1975), p. 15.

*** *See, e.g., Blackmer, supra*, p. 259.

**** The deductibility of religious contributions is, of course, not defensible under this rationale. It is usually justified as the best way for the government to avoid "entanglement" with religious organizations, in compliance with the first amendment.

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or for the prevention of cruelty to children or animals,"[*****] activities which benefit the public at large rather than the donor and are often also directly subsidized by the government.

We believe this limitation is wise tax policy, and that an exception should not be made for the Masons. Not only would such an exception be intrinsically wrong, but, like the depletion allowance, it would likely expand greatly in the future, as other groups queued up for similar favors.[******] We urge that S. 616 not be favorably reported.

S. 736. Independent Contractors

This bill attempts to deal with some of the problems involved in the "independent contractor" controversy by establishing a set of "safe harbor" criteria. Under these rules certain workers and their employers could elect independent contractor status for the workers. The bill is a companion to a proposal by Rep. Gephardt in the House. Although we respect the good intentions of the draftsmen of S. 736, we do not believe it to be an acceptable solution to the independent contractor problem, and we must oppose it.

Initially, we should make clear that we start with a bias in favor of treating workers as "employees" whenever convenient and feasible – a bias we believe the members of Congress should share. There are several reasons for our position:

First, the evidence is very clear that tax compliance is higher when taxes are withheld. The IRS has just completed a study showing that only about half of all workers treated by payors as independent contractors report their compensation on their tax returns. In addition, anyone who has had substantial experience with independent contractors knows that many of them are at best cavalier about their tax obligations. Failure to pay taxes by some members of society means, of course, a higher tax burden on the rest of us.

Second, workers treated as "employees" are often entitled to participate in tax-favored benefit plans, such as pensions and medical insurance, which are usually denied to independent contractors.

Third, workers treated as independent contractors are not entitled to unemployment insurance coverage, and may lose out on social security benefits.

We recognize that some individuals, for practical reasons, cannot be treated as employees. But we believe that the exceptions ought to be made for reasons related to the practical difficulties involved. And we also believe that an altered form of withholding can often be used when graduated withholding is impractical.

[*****] In certain cases, contributions to organizations established to foster amateur sports, to non-profit cemetery companies, and to veterans posts are also deductible.

[******] The next most likely candidates would be the Elks and the Moose, tax-exempt under Section 501(c)(8), rather than 501(c)(10), because they provide insurance benefits to members

The current criteria for distinguishing employees from independent contractors stem from the common law of torts and agency, and were originally used only to determine when a "master" should be liable for harm caused by a "servant" under the "deep pocket" rationale. Conceptually, the tort liability issue has little to do with the withholding question, since the latter is concerned only with collection, not with imputed liability. In practice, however, the main factor for finding vicarious fault on the part of a "master" – i.e., control – has coincidentally turned out to be an acceptable standard in most cases for finding withholding of taxes to be convenient and feasible.

It is precisely because the "control" standard does *not* always approximate a "convenience and feasibility" standard that the independent contractor issue is currently vexing the Congress, the IRS, and affected taxpayers. We believe that it is incumbent upon the Congress and the Treasury to develop a new approach to the classification problem which both rationalizes the definition of "independent contractor" and minimizes the distinctions which rest upon the definition.

S. 736 does not focus very well on the convenience and feasibility issues. In particular: (1) Control of hours worked, a carryover from the common law standard, does not appear to have any particular relevance to whether withholding is practical; (2) The place of business rule can be relevant in some cases to whether a worker has substantial work-related expenses, but making no place of business and many places of business equivalent to providing ones own place does not make sense; and (3) while having a substantial investment in assets is also relevant to whether withholding is feasible, the fact that earnings are dependent upon performance or output does not appear to be an important, or even germane, factor. Some of the situations in which independent contractor status would be possible under S. 736 include:

(a) Bill is an attorney working as an associate with the firm of Ketchum, Cheatum, and Runne. Depending upon the ebb and flow of business and how fast he works, Bill's hours can vary from 40 to 70 per week, and his starting time can range from 7:30 to 10:00 a.m. Although he performs much of his work in his office, Bill also spends a substantial amount of time in the hearing rooms of the Ways and Means Committee and the Senate Finance Committee. Bill is paid a salary plus a year-end bonus. The size of the bonus depends in large part on his productivity in promoting the interests of the firm's clients. Bill could be treated as an independent contractor under S. 736 if he and/or his firm so desires.

(b) Jill is a plumber working full-time for the Ace Plumbing Co. When Ace receives a contract – say, to install a heating system in a residence – it will give the work order to Jill. She will be told to complete the work by a certain date and when to start. If Jill finishes a job early, she will usually come back for more work. The exact time Jill begins and ends work each day depends upon her deadlines, how she feels, and so forth.

Also, how long a job takes depends largely on how difficult it turns out to be. Since Jill performs work at various sites during the year, she has no principal place of business. Jill has invested several hundred dollars in tools – wrenches, screwdrivers, torch, etc. – although some of the more heavy duty equipment is furnished by Ace. Jill could be entitled to independent contractor status under S. 736.

(c) Richard is a higher level federal employee participating in the new manager incentive program. He is on flex-time. Frequently, he brings work home with him and spends several hours on it. Richard could be treated as an independent contractor under S. 736.

(d) Senator X is a member of the U.S. Senate. He works between 50 and 100 hours a week. Usually his work day begins at 7:30 a.m., but it sometimes starts as early as 5 a.m., and other times as late as 9 a.m. The Senator has an office on Capitol Hill, one in his home, and one in his home state. In order to facilitate his frequent trips home to take the pulse of the electorate, the Senator owns a private plane which cost him $50,000. Senator X could be treated as an independent contractor.

(e) Mr. Meany runs an electrical contracting firm which employs 12 electricians. He would like to set up a tax-deductible pension plan and medical reimbursement plan for himself, but cannot without also providing coverage for his workers. Upon passage of S. 736, however, Mr. Meany insists that all his electricians sign contracts converting them to independent contractor status, for which they qualify as in case (b) above.

We could not endorse S. 736 even if its scope had been successfully limited to satisfying the demands of the constituent groups complaining the loudest about IRS's increased audit activity in the independent contractor area, because we do not believe the bill's standards make conceptual or practical sense. The bill's failure to have a narrow application, however, illustrates how difficult it is to come up with language which provides a satisfactory definitional solution to the problems surrounding this issue.

With that caveat, we would suggest the following as some of the principles which could be applied in classifying workers as employees or independent contractors for income tax withholding purposes:

(1) All workers without substantial work-related expenses should be classified as "employees" (unless treated as self-employed under (3) or (4) below). "Substantial" should be defined, as equal to, say, 30% of gross payments.

(2) All workers employed by only one payor should be classified as "employees" (unless treated as self-employed under (3) or (4) below). With only one payor, withholding adjustments can easily be made in cases in which work-related expenses are substantial. This rule might be extended to 3 or 5 payors.

(3) All workers who themselves have business employees should be classified as self-employed.

(4) For non-business payors, only essentially full-time workers (e.g., live-in maids or governess, but not babysitters or repairmen) should be treated as "employees."

Unfortunately, these rules do not work so well with regard to social security taxes, where withholding adjustments and refunds are not as easily available

as they are with regard to income taxes. It may, therefore, be necessary to amend the payroll tax laws to take better account of non-reimbursed work-related expenses of employees.

Because of the hostility and bitterness which currently surrounds the independent contractor issue, enactment of principles such as we have suggested would be difficult at this time, even if critical analysis shows them to be sound. Recognizing this problem, the Treasury Department offers an approach which is designed, not to rationalize the definition of "independent contractor," but to reduce the consequences which hang on the classification. Thus, flat-rate income tax withholding (at 10%) would be required except where a worker has very substantial work-related expenses or more than 5 payors. Assuming a payor complies with this requirement, the only penalty for misclassification would be the employer's share of FICA and FUTA taxes, an enormous reduction in penalty from current law.

We think the Treasury proposals are an excellent first step in this area, and would help tremendously to reduce the tensions which have arisen over the "independent contractor" issue. We endorse Treasury's plan and urge its quick enactment.

At the same time, however, we think the Congress should continue to explore possibilities of improving the definition of "independent contractor." Although its income tax importance would be reduced under the Treasury proposals, it would continue to affect social security coverage, unemployment benefits, and pension plan inclusion.

S. 1514. Exemption from the Restrictions on Industrial Development Bonds for Certain Recycling and Energy Generation Carried Out in Connection with Solid Waste Disposal Facilities.

Insofar as S. 1514 extends the use of industrial development bonds we are opposed to it. Such bonds are a particularly inefficient form of government subsidy and do violence to the fairness of the tax system, because about 40% of the federal revenue loss goes in windfalls to wealthy investors. If the activities described in S. 1514 are worthy ones, and are in need of additional subsidies because of imperfections in the current market structure, we believe the subsidies should be made directly.

Senator DOLE. The committee will stand in recess until the call of the Chair. Thank you.

[Whereupon, at 12:55 p.m. the subcommittee recessed, to reconvene at the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

United States Senate
WASHINGTON, D.C. 20510

September 17, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Taxation and Debt Management Subcommittee
Committee on Finance
U. S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

As co-sponsor of S. 1514, I welcome the opportunity to present today my views before your Subcommittee as it considers this important piece of legislation.

In particular, I applaud the initiative that you have taken in coming forward with positive legislation that will push us on our way to achieving our goal of energy independence.

For America to continue to grow and prosper and not be dominated and dictated to by the pricing whims of foreign oil producers, we as a nation must become energy independent by developing our own primary and alternative energy resources.

One highly promising alternative energy resource is that of converting solid waste into energy, most typically steam and electricity. This energy alternative successfully recycles waste that would otherwise be discarded, and contributes dramatically to solving environmental problems of where and how to dispose of the waste.

A major concern at present is municipal post-consumer solid waste, which is currently being generated at a rate of about 144 million tons per year, at a disposal cost of approximately $4 billion annually. The Council on Environmental Quality reported in January of this year that the costs of waste management to both the private and public sectors during the decade ending in 1986 may exceed $94 billion.

To be economically feasible, energy recovery systems utilizing solid waste are said to require at least 600 to 1000 tons delivered per day at each site. Thus, areas which are densely populated or have regional collection systems possess the greatest immediate potential for converting solid waste into energy.

Despite problems of economic feasibility, municipalities in approximately 40 community areas across America are already taking direct action on their environmental and energy resource concerns through solid waste energy conversion.

One of these communities is in southeast Virginia. The Southeastern Public Services Authority, serving a combined population of 750,000, has invested $2.2 million dollars in a solid waste disposal facility. The Authority plans to collect solid waste from each of the participating seven counties and cities, convert it to steam and then electricity, and sell the electricity to the Norfolk Naval shipyard in Portsmouth, Virginia.

Unfortunately, however, until certain clarifications are made in the Internal Revenue Code, the Southeastern Public Services Authority will continue to face economic hardship and may be prevented from even beginning its actual conversion of waste into steam and electricity.

S. 1514 would alter the Internal Revenue Code in two basic ways, both of which would facilitate the efforts of this Authority and many others like it to utilize solid waste for energy purposes.

First, the bill would permit tax-exempt revenue bond financing by states and their political subdivisions for constructing municipal solid waste disposal facilities where energy is produced and sold to the Federal Government. (Current law allows for tax-exempt revenue bond financing when the energy end-products are sold to the private sector.)

In addition, S. 1514 would allow tax-exempt revenue bond financing of electrical generating equipment which is an integral part of a solid waste disposal facility. This section of the bill modifies present IRS regulations, which extend tax exemptions only to the waste disposal portion of a facility.

Without the changes that S. 1514 would provide, the bold plans of the Southeastern Public Services Authority cannot be fully realized. Southeastern Virginia will face the loss of more than a $2.2 million investment, and will be forced to return to more traditional means of solid waste disposal in a less energy-efficient manner.

In my judgment, the conversion of solid waste for energy purposes is an idea whose time has come. The federal government must encourage, not discourage, municipal efforts to produce solid waste disposal facilities for energy converion. Without the alterations made in the Internal Revenue Code by S. 1515, their efforts will be severely, if not totally inhibited.

In conclusion, Mr. Chairman, let me again express my appreciation for your sponsorship of S. 1514, and extend my thanks to the Subcommittee for the opportunity to contribute to its consideration of this important measure.

Respectfully,

John W. Warner

JWW/jum

ROBERT W. DANIEL, JR.
4TH DISTRICT, VIRGINIA

COMMITTEES:
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September 11, 1979

The Honorable Harry F. Byrd, Jr., Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
Senate Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

As you know, we have introduced H.R. 4988, a companion bill to S. 1514 which you introduced to amend the Internal Revenue Code of 1954 with respect to interest on certain governmental obligations, the proceeds of which are to be used to provide solid waste disposal facilities.

Obviously we are in favor of this legislation and are delighted that you are holding a hearing on the subject. This letter, for the record, is simply to express the hope that your subcommittee will report the bill favorably.

With kind personal regards.

Sincerely,

Bill

G. William Whitehurst

Bob

Robert W. Daniel, Jr.

STATEMENT OF DEAN C. MATHEWS
ON BEHALF OF THE
SPECIALTY ADVERTISING ASSOCIATION INTERNATIONAL

Mr. Chairman, I am Dean C. Mathews, president of the Shedd-Brown Company of Minneapolis, Minnesota. I am appearing today on behalf of the Specialty Advertising Association International in my capacity as Chairman of the Board of that Association.

I wish to say at the outset that our Association strongly supports S. 736 and we commend Senator Dole for introducing it. We oppose the Treasury Department proposal for a flat 10 percent tax withholding.

The Specialty Advertising Association is the trade association that represents the specialty advertising industry. Its 2000 member firms, located in virtually all states, manufacture or distribute specialty advertising products. Specialty advertising is an advertising medium which uses useful but inexpensive products to carry an advertising message. Examples of such products are ball-point pens, key chains and calendars, which are custom-imprinted with the name, logo or other message of the advertiser and distributed free of charge for their promotional value.

Specialty advertising products may be sold by manufacturers directly or through distributors. Both direct sellers and distributors receive orders from salespeople who make the actual contacts with the advertisers. The salespeople typically derive their income solely from commissions

and operate away from the premises and free from the control of their principals. There are approximately 30,000 of such salespeople, the great majority of whom are treated as independent contractors.

It is apparent that in recent years the Internal Revenue Service has radically altered its approach to employment tax enforcement. As a result, increasing numbers of business firms, including several in our industry, have been faced with back tax assessments, many involving huge sums. In seeking these assessments, IRS has been asserting that many groups of individuals traditionally viewed as independent contractors under the common law test, and treated as such, are actually employees. This abrupt retroactive reversal of settled policy has had a damaging and disruptive effect on our industry and on many others.

Interpretations long acquiesced in become a part of the context in which business plans and acts, and Congress legislates. It is not too much to state, as Justice Powell implied in his concurring opinion in Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978), that it is improper and unfair for IRS to ignore apparently settled interpretations of law without giving notice to taxpayers of its intention to do so. Nevertheless, IRS demonstrably feels it has the power, even the duty, to pursue its present

course. For that reason it is idle to say -- as some continue to say -- that new legislative definitions are unnecessary in this area. While some may feel satisfaction in knowing a court challenge to an IRS assessment will probably succeed, for the great majority of small businesses even the prospect of having to seek relief through the courts will be seen and felt as a failure of the system. Although the enactment last year of H.R. 14159 provided valuable interim relief, it provides no protection against future IRS intransigence in the enforcement of employment tax laws.

So long as statutory standards for the employee/independent contractor distinction are vague, IRS will continue in the fallacy that the thrust of its new emphasis on that distinction is not defining standards but enforcing them.

The problem is the absence of a clear definition for the future. Mr. Chairman, we believe S. 736 provides an effective solution to that problem. The statutory "safe harbor" tests it contains are clear and understandable. They may be applied by business firms and individual workers without the necessity of tax counsel. More importantly, because of their clarity, they are not susceptible to being misinterpreted by the IRS.

In addition, we believe the tests fairly embody the basic common law concepts of the independent contractor -

that is, a person who is free to determine when and how long he will work, with no guaranteed or fixed income. A worker who meets all of the bill's five tests <u>ought</u> to be treated as an independent contractor.

In our view the Treasury Department's recent proposal for a flat 10 percent tax withholding on independent contractors would be highly unsatisfactory. This proposal is far too drastic; it would subject our industry to an enormous bookkeeping burden which we believe is unwarranted. Moreover, the proposal really does not even address what we regard as the basic problem; namely, the lack of a clear, easy to apply test for determining independent contractor status. It would require the application of the same difficult and highly subjective common law test.

In sum, we urge enactment of S. 736 and rejection of the Treasury Department proposal.

Thank you.

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September 26, 1979

The Honorable Harry F. Byrd, Jr.
Member, Senate Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Byrd:

We represent the Council of American Survey Research Organizations (CASRO), a trade association which represents organizations involved in full-line market and other general survey research. CASRO includes among its members most of the prominent firms engaged in this type of research which is now performed for nearly every manufacturer, advertising agency, and media entity in the United States, as well as a broad range of governmental agencies.

Your Committee now has before it a very important piece of legislation which, in its present form, we believe to be fundamentally defective. We are referring to H.R. 3245 (S. 736) which establishes a new standard for determining whether certain individuals are "employees" or "independent contractors" for purposes of federal employment tax payments.

On July 17, 1979, our organization addressed the House Subcommittee on Select Revenues in opposition to H.R. 3245. Our objections to the legislation at that time focused on the inflexible wording of the income fluctuation provision of the so-called "safe-harbor" test, which restricts any worker paid on an hourly basis from qualifying as an independent contractor.* A copy of our written comments is enclosed.

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* That section provides in relevant part that:

> "the individual risks income fluctuation because his remuneration with respect to such service is directly related to sales or output rather than to the number of hours actually worked."

Although the reasons for CASRO's original concern still stand, additional serious considerations have now come to our attention. We would like to take this opportunity to bring our most serious objection to your attention.

The only way that CASRO member organizations, and presumably many other industries, could satisfy the "income fluctuation" requirement would be to compensate workers solely on an output or piece-rate basis, instead of the current hourly wage practice. While this may not appear to be an impossible burden, we have been informed from several of our members that other existing federal laws prevent them from compensating workers in this manner.

Beginning several years ago, the Department of Labor communicated with companies in our industry informing them that their practice of piece-rate remuneration could be construed as an evasion of the minimum wage provisions of the Fair Labor Standards Act, 29 U.S.C. § 206-207 (1970). It is clear that CASRO members will be faced with the following unpleasant dilemma: either remunerate on the basis of output and possibly violate fair labor standards, or pay an hourly wage and immediately forego the safe-harbor and have their workers classified as employees. As we noted in our Congressional testimony, the tax status of interviewers, as employees or as independent contractors, is of substantial concern to CASRO members whose costs of doing business are significantly affected by employment tax contributions and the overhead burden of withholding, accounting, remitting, and reporting.

We have inquired as to why the Department of Labor did not itself address the discrepancies between H.R. 3245, S. 736 and the Fair Labor Standards Act. Our discussions with Labor Department personnel satisfy us that, in fact, they have been aware of the possible impact of independent contractor tax legislation on the Fair Labor Standards Act. Their failure to speak up is inexplicable.

Further, it is ironic that a second government agency, the Bureau of the Census (with operations closely related to those of CASRO members) has applied for and received relief from the dilemma presented by the Fair Labor Standards Act (FLSA) and the proposed tax legislation. The Bureau of the Census, like CASRO member organizations, contracts with thousands of individuals to interview the public on a one-time or limited contact basis. In order to ensure that FLSA does not inhibit remuneration on a piecework method, the Bureau lobbied for that provision of Pub. L. 95-431, which reads:

> "Provided, that certain enumerators for the 1980 Decennial Census may be paid on a piece rate basis without regard to the provisions of 29 U.S.C. 206 and 207."

The Bureau of the Census has also failed to address itself to H.R. 3245 and S. 736. With the aim of discovering the Bureau's reasons for seeking the exemption, CASRO has instituted a request under the Freedom of Information Act in order to obtain whatever background documents may be available. Should the search prove to be fruitful, we will forward copies to the Subcommittee.

In conclusion, I would like to reiterate our basic objections to H.R. 3245. First, it sets forth a shallow, artificial and confusing two-step approach to the problem of distinguishing independent contractors from employees. Second, the bill appears to have been drafted in order to placate certain special interest groups by remedying their specific problems without apparent regard for other socially desirable legislation, namely FLSA. Finally, failure to define such key terms as "asset" and "income fluctuation" in the safe-harbor provision of the text of the bill will engender as much confusion regarding tax status as did the common law test.

CASRO applauds the efforts of those on the Hill who have taken it upon themselves to clarify and update the labyrinth of the common law. However, when bright-line tests are chosen which do not accurately reflect the real world concept of the fundamental differences between an "employee" and an "independent contractor", then such tests must be refined or reshaped. We therefore urge you and each of the members of the Subcommittee to carefully scrutinize the wording of this bill, and to make the appropriate modifications before it is passed to the full Committee. We will be in touch with your staff in the near future in connection with this matter.

Sincerely,

Richard B. Lavine

RBL/cmm
Enclosure

STATEMENT OF SANFORD L. COOPER
CHAIRMAN, COUNCIL OF AMERICAN SURVEY RESEARCH ORGANIZATIONS
BEFORE SUBCOMMITTEE ON SELECT REVENUES
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

My name is Sanford L. Cooper and I represent the Council of American Survey Research Organizations (CASRO). We appreciate the opportunity to testify before the Subcommittee this morning on the tax status of independent contractors and particularly H.R. 3245. Before discussing our objections to that particular bill permit me to describe briefly the market research survey organizations who are members of CASRO, the work of CASRO, and the problems these groups have experienced with the Internal Revenue Service over the past several years.

CASRO is a business trade association formed four years ago to represent the organizations involved in full-line market and other general survey research. CASRO includes among its members most of the prominent firms engaged in this type of research which is now performed for nearly every manufacturer, advertising agency, and media entity in the United States as well as a broad range of governmental agencies.

In conducting market survey research CASRO member organizations have the need to use the services of thousands of interviewers throughout the country. On occasion these interviewers contract directly with CASRO members, although often they are hired by independent field organizations which then negotiate with CASRO members to conduct the necessary interviews. In either case, the tax status of the interviewer, as an employee or independent contractor, is of

substantial concern to CASRO members whose costs of doing business are significantly affected by employment taxes.

Although all market survey organizations do not conduct their research activities in an identical manner, we would ask the Subcommittee to focus on a representative company which recruits individuals to conduct the necessary interviews by means of newspaper advertisements, contact with employment agencies, and schools, among other sources. These individuals, many of whom are housewives, students, or other persons whose availability is generally uncertain, contract to interview a sampling of the public, by telephone or in person, and to fill out questionnaire forms which report the results of the interviews. These tasks, performed on a short term basis, are usually performed away from the business premises of the company, and according to hours set by the worker. The company's control over the individual is usually limited to a brief instruction period - usually by mail or telephone - at the beginning of an assignment and involves limited ongoing supervision. The interviewers generally do not maintain a continuing relationship with a single company, but accept spot work as it becomes available from many companies in the industry. The income derived from these activities, whether paid on an hourly or per interview basis, is, therefore, subject to wide fluctuation and the risk of extended periods of unemployment is continuing and severe. The surveying company, while reimbursing certain expenditures, may require

its interviewers to use their own telephones, automobiles or other personal property to conduct their research.

For years market survey research organizations have been convinced that the interviewers who perform the functions just described are independent contractors under the common law test of the Internal Revenue Code (26 U.S.C. 3121(d) (1970)). CASRO members and other research groups have applied the twenty factors developed by the tax agency to establish the employment status of workers (Internal Revenue Manual 8463) and have made a good faith determination that the large majority of research interviewers working in this industry are self-employed. The IRS has not always agreed, however, and the result has been continuing harrassment and unnecessary and non-productive tax audits.

Like many of the groups that will testify before your Subcommittee this week, CASRO members have suffered through years of confusing and inconsistent IRS positions on the employment status of research interviewers. Even today, nearly fifteen years after the Revenue Service's first major ruling in this area, many market research groups have no guidance or direction on this vital issue which directly affects the day-to-day operations of hundreds of businesses. A very brief history of some of the sources of the present disorder is now in order.

In Revenue Ruling 65-188, 1965-2 C.B. 390 (Attachment A) it was determined that certain market research interviewers are self-employed provided they are part-time workers, free

from significant supervision or control, and permitted to refuse certain assignments. The Ruling further provided that, depending on the circumstances, the interviewers may be paid by the hour, or according to a specified fee per interview, and receive reimbursement for certain expenses.

Ten years later Revenue Ruling 75-243, 1975-1 C.B. 322 (Attachment B) distinguished the earlier Ruling and found certain interviewers to be employeees, apparently on the basis of a greater degree of control exercised by the research organization. In recognition of the fact that the two previous Rulings could not be reconciled so as to be applicable to a given factual setting, a third Revenue Ruling (78-284) was issued in 1978 (Attachment C), which "effectively limited" but did not specifically overrule the 1965 Ruling. Finally, on January 22 of this year the Internal Revenue Service issued Letter Ruling 7916104 (Attachment D) which, on circumstances similar to those under which the majority of the industry operates, and largely indistinguishable from those presented in the 1975 and 1965 Rulings, concluded that market research interviewers were not employees for purposes of the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Federal income tax withholding.

CASRO, like many other similarly situated organizations, had hoped that the Congress would legislate a comprehensive solution to the problem inherent in classifying workers as independent contractors once the Conferees on the

Tax Reform Act of 1976 requested the staff of the Joint Committee on Taxation to make a general study of the area, and the General Accounting Office began to prepare its own report on the same subject. Both these studies have arrived at the rational conclusion that the primary cause of the present state of confusion is the absence of development of a universal, simplified set of criteria against which the tax status of a worker could be determined, not only by the Internal Revenue Service, but also in the first instance by the employer and individual worker. The adoption of such a standard would obviate the need for costly audit procedures and would provide a sense of fairness and uniformity to the tax code. H.R. 3245, now pending before this Subcommittee, fails to clarify the present vague common law standard and, if enacted in its present form would only contribute to the arbitrariness and confusion inherent in the present system.

H.R. 3245 essentially provides two means by which a worker could establish independent contractor status. The first involves what has become known as the "safe harbor" test. The second resurrects the common law standard. To qualify under the "safe harbor" test five requirements must be met. These requirements relate to : (1) control of hours worked, (2) place of business, (3) investment or income fluctuation, (4) written contract and notice of liability, and (5) filing of required returns. The ability to satify these

provisions conclusively establishes independent contractor status; failure to do so subjects the individual to the burden of establishing his employment status via the common law.

CASRO objects to H.R. 3245 on the following grounds: (1) the bill fails to provide the comprehensive solution to the independent contractor issue envisioned by the passage of Section 530 of the Revenue Act of 1978 but, rather, suggests a shallow, artificial, and confusing two step approach to a situation crying out for one set of rules for everyone; (2) the lack of definition inherent in key provisions of the "safe harbor" test, such as the meaning of "asset" and "income fluctuation" in the third requirement, is certain to inject more uncertainty into an already murky situation; and (3) the bill would appear to be drafted to placate certain special interest groups, who have frequently introduced their own bills to remedy their special problems, while subjecting others to the common law rules from which relief is essential. I will cite one illustration of the shortcomings we perceive in H.R. 3245.

Bear in mind the nature of the work performed by market survey research interviewers which we described earlier. In this setting, CASRO has a manifestly legitimate basis on which to assert that these workers are, for the most part, independent contractors. The "safe harbor" test, however,

is not available to most CASRO members because of the artificial and unrealistic rigidity of part "b" of the third requirement which provides that:

> [t]he individual risks income fluctuation because his remuneration with respect to such service is directly related to sales or other output rather than to the number of hours actually worked. (Emphasis supplied).

Whether CASRO members compensate their workers by the hour or by the interview cannot reasonably have a substantive effect on the relationship of the company to the worker. Yet, under the present test, form prevails over substance. The most recent IRS Letter Ruling on this topic did not find hourly compensation to be a material factor. In fact, if "income fluctuation" is to be a criterion, then the interviewers of this world meet the standards handily in light of the lack of continuity associated with their work.

The approach of H.R. 3245, like that of several bills introduced in the last session which were not enacted, is designed to assist a handful of industries when dozens of others are adversely and severely affected. For years, many employers have in good faith consistently treated individuals as independent contractors. These employers, who have been continuously harrassed by the IRS audit practices and regulations, will receive no relief from this proposed legislation. After years of anticipation that Congress would finally develop a comprehensive, even-handed, and nondiscriminatory test of employment status, it is most disappointing to find

that a bill such as H.R. 3245 is even under serious consideration. The common law test, so widely criticized, would remain the primary standard a worker would have to satisfy in order to establish that he is an independent contractor should this bill be enacted.

It is not CASRO's intention to suggest the criteria for establishing whether an individual is an employee or independent contractor. This is a resposibility the Congress undertook when it enacted Section 530 of the Revenue Act of 1978, and it is a subject about which this Subcommittee can draw upon a wide body of expertise not found within our organization. CASRO does request that the Congress legislate a fair standard which would clarify the present vague common law, and promote uniform enforcement by the Internal Revenue Service.

In closing, we would like to remind the Subcommittee of the often cited prophetic words of Adam Smith some two hundred years ago:

> "The tax which each individual is bound to pay ought to be certain, not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. ... The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality ... is not near so great an evil as a very small degree of uncertainty."

We ask you, most respectfully, to pay attention to those words.

Attachment A

Rev. Rul. 65-188

SYNOPSIS

In conducting surveys of the response to certain types of advertising, the X corporation engages individuals on a short-term basis to interview the public, by telephone or in person, and to fill in questionnaire forms reporting the results of the interviews. The interviewers are free from supervision or control in doing the work, and the X corporation is interested only in the results as reported in completed questionnaires. Depending on the circumstances, the interviewers are paid either by the hour or a specified fee per interview, and they may receive reimbursement for telephone or travel expenses. Dealings between the X corporation and the interviewers are generally by mail. The interviewers are free to refuse any assignment, and to work whenever they please subject to the specifications of a particular job. Held, the interviewers are not employees of the X corporation for Federal employment tax purposes; however, each is engaged in a trade or business for purposes of the Self-Employment Contributions Act of 1954.

Advice has been requested whether "resident interviewers" who obtain information from the public are employees of the X corporation for Federal employment tax purposes.

The X corporation is in the business of making surveys of the public response to certain types of advertising, either nationwide or in smaller areas. Representatives of the X corporation, located in different parts of the United States, maintain lists of individuals who are available to perform interviewing services in the areas in which they reside. The resident interviewers, many of whom are housewives or students, perform the services on a part-time basis. New interviewers are given a 2- or 3-hour training class by the X corporation's representative, but subsequent communications with the interviewer are usually by telephone or mail.

Whenever the X corporation desires interviews in a certain area, its representative mails questionnaires and specifications to selected resident interviewers in the area. The specifications state the amount and basis of

payment for the services, the amount, if any, of telephone or travel expenses for which reimbursement will be allowed, and any special requirements for the particular assignment. Examples of special requirements are the restriction of interviews to a particular time of day, the obtaining of a specified percentage of interviews with men or with women, or the completion of the work within a time limit. An interviewer who does not wish to accept an assignment is free to return it for reassignment.

If the resident interviewer accepts an assignment, the work is to be done as specified, but without any other supervision or control by the X corporation or its representative. The interviewer mails the completed questionnaires to the X corporation's representative, who validates a sample of the work by conducting short re-interviews by telephone. The X corporation pays the interviewer the agreed amount which, depending on the nature of the assignment, may be based either on the time spent or the number of interviews completed. The interviewer is paid whether or not the results of the interviews are entirely satisfactory, but further assignments are not given to an interviewer who repeatedly produces poor results.

Each assignment to a resident interviewer is for a specific project which normally requires only a short period of time. In accepting an assignment, an interviewer is responsible for producing results according to specifications, may engage helpers for this purpose, and is not obligated to perform the work personally. The interviewer is free to accept nonconflicting assignments from other survey organizations. There is no continuity of relationship between the X corporation and the resident interviewer; and after completing an assignment, the interviewer has no further relationship with the X corporation unless and until another assignment is received and accepted by the interviewer.

Under section 3121(d)(2) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954), the term "employee" means, among other things, any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. The guides for determining, under these rules, whether an employer-employee relationship exists, are found in section 31.3121(d)-1(c) of the Employment Tax Regulations.

It is concluded, upon the basis of the stated facts, that the X corporation neither exercises, nor has the right to exercise, such control and direction over the resident interviewers as is necessary to establish the relationship of employer and employee under the usual common law rules. The X corporation is interested only in the results obtained by the resident interviewers and does not direct or control the interviewers as to the details and means by which the results are accomplished. Accordingly, it is held that the interviewers are not employees of the company for purposes of the Federal Insurance Contributions Act.

This conclusion is also applicable for the purposes of the Federal Unemployment Tax Act and the Collection of Income Tax at Source on Wages (chapters 23 and 24, respectively, subtitle C of the Code). Furthermore, each interviewer is engaged in a trade or business, the income from which should be taken into consideration in computing net earnings from self-employment, for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A of the Code).

Attachment B

Rev. Rul. 75-243

SYNOPSIS

Market research survey interviewers. Interviewers paid on an hourly basis to conduct market research surveys, for a company that hires from its list of people who want to conduct interviews on a permanent basis, issues specific instructions for conducting interviews, may select the interview site, sets quotas and deadlines for completion, does not permit the interviewers to hire assistants or substitutes, and requires daily reports, are employees of the company; Rev. Rul. 65-188 distinguished.

Advice has been requested as to the status of an individual performing services for a company, under the circumstances described below, for purposes of the taxes imposed by the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954).

The company is engaged in the business of conducting market research surveys for its clients, and recruits individuals to perform services for it that consist of the gathering of the market research data from members of the public.

The company maintains a permanent list of potential interviewers that have expressed a desire to perform these services on a permanent basis. When the company receives a request from one of its clients, it contacts an interviewer and engages his services pursuant to an oral agreement. Under the agreement the interviewer receives his assignments by telephone and is expected to pick up the necessary interviewing forms, instructions, and other material at the company's office. While the interviewer is not required to accept every assignment offered, if he does accept, he is given a deadline for completion and a quota of interviews that must be completed. The amount of time for completion of an assignment varies with the nature of the survey project and the number of interviews that must be completed.

The interviews are generally conducted wherever the people to be interviewed can be found, such as shopping centers, stores, homes, etc. Generally, an interviewer may select his own interviewing area. However, when a large number of interviewers are working on a single project the company furnishes each with a specific geographical territory. Each interviewer is given specific instructions as to the qualifications of the people to be interviewed and is supplied with printed questionnaires. The company requires that only those questions be used during the interview. In the event an interviewer cannot complete all of his assigned interviews the company will engage another interviewer to help complete his interviews. The interviewer is required to complete his services personally, cannot engage assistants or replacements, and is required to report to the company daily on his progress.

When an interviewer has completed his assignment and turned in the interview forms to the company, a company representative calls a certain percentage of those persons interviewed to verify that an interview was conducted and that the proper questions were asked. The company may terminate the interviewer's services for repeated failure to complete assigned projects, falsifying reports, or for failure to follow instructions.

The interviewer is paid on an hourly basis, and is expected to furnish his own transportation, telephone, and supplies, such as pencils and clipboards. The company reimburses each interviewer for transportation expenses such as parking fees, tolls, gas and oil, incurred in performing the services. In addition, the company reimburses each interviewer for the cost of a license or permit, if one is required.

An individual is an employee for Federal employment tax purposes if he has the status of an employee under the usual common law rules applicable in determining the employer-employee relationship. Guides for determining whether that relationship exists are found in three substantially similar sections of the Employment Tax Regulations, namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1. Generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work but also as to the details and means by which that result is

accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct and control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge the individual is also an important consideration.

Rev. Rul. 65-188, 1965-2 C.B. 390, considers the status of a resident interviewer engaged by a corporation on a short-term basis to interview the public by telephone or in person, and to fill out questionnaire forms reporting the results of the interview. A new interviewer is furnished with a brief training period by a representative of the corporation. After this initial period all other contact between the resident interviewer and the corporation is usually by mail or telephone. The interviewer is not required to perform the work personally, and is free to accept or decline an assignment. If an assignment is accepted, it is to be done according to specifications provided by the corporation, but without its supervision. Under these circumstances, Rev. Rul. 65-188 holds that the resident interviewer who obtained information from the public is not an employee of the corporation for Federal employment tax purposes.

The facts in this case are distinguishable from those presented in Rev. Rul. 65-188. In this case the interviewer is obligated to personally perform the services, is issued specific instructions with respect to conducting the interview, the type of people to be interviewed, the questions to be asked, and is required to report his progress to the company on a daily basis. Generally, the interviewer determines where the interviews will be conducted. However, the company retains the right to designate certain areas when it deems such action appropriate. Although the interviewer does not require constant supervision, the company has retained the right to control and direct the interviewer to the extent necessary for the satisfactory conduct of its business.

Accordingly, in the instant case, the interviewer is an employee of the company for purposes of the taxes imposed by the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages.

Rev. Rul. 65-188 is distinguished.

Attachment C

Rev. Rul. 78-284

The Internal Revenue Service has been asked to reconsider the distinctions made in Rev. Rul. 75-243, 1975-1 C. B. 322, between the facts in that Revenue Ruling and the facts in Rev. Rul. 65-188, 1965-2 C. B. 390.

Rev. Rul. 75-243 holds on the basis of facts stated therein that interviewers are employees for Federal employment tax purposes. Several factors are listed distinguishing that ruling from Rev. Rul. 65-188, which holds that interviewers are not employees.

Rev. Rul. 65-188 implies that individual interviewers of the type described therein will never be considered employees. Upon reconsideration it is concluded that the issuance of Rev. Rul. 75-243 effectively limited Rev. Rul. 65-188.

Accordingly, pursuant to the authority provided by section 7805(b) of the Internal Revenue Code of 1954, Rev. Rul. 75-243 will be applied without retroactive effect with respect to wages paid before July 1, 1975.

53-845 O - 79 - 41

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(Code Secs. 3121, 3306 and 3401)

Definitions; Employees; Common law test; Employer-employee relationship; Employee v. not an employee; Interviewers and area representatives; Withholding of tax on wages.--CCH.

This is in reply to your request for a ruling as to whether certain interviewers and area representatives are your employees for purposes of the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Federal income tax withholding.

In accordance with our usual practice in ruling requests involving the status of workers, we obtained information from several of the workers because their interests will also be affected by our conclusions. The information from them agrees substantially with that furnished by you.

The information shows that you are a market research company that conducts surveys for national advertisers, advertising agencies, and others. In conducting the surveys, you engage the services of the interviewers and area representatives whose status is in question.

When you have an assignment in the market area covered by the interviewer or area representative you call to inform the worker that the assignment is in the offing and to determine her availability to cover the job. If she is available, you send her the necessary information for which you agree to pay her at an agreed-upon rate when the completed work is returned to you.

The interviewers receive only initial brief training from area representatives on telephone interviewing techniques. All subsequent contact is by mail or telephone. They conduct the interviews from their own homes via telephone. The specifications for the interviews and the necessary interviewing forms are provided by you.

The interviewers and area representatives are not required to perform the work personally and are free to hire and use assistants. If assistants are used, you expect the work to be of the same quality as that performed by the workers themselves. The workers are free to refuse assignments and to work for other firms. They are engaged on a job-by-job basis, and cannot be terminated during an assignment. They are not required to make daily progress reports and are responsible only for the satisfactory completion of the job.

The interviewers are paid on an hourly basis and are reimbursed for expenses incurred in performing the services. The area representatives are similarly paid on an hourly basis plus expenses for interviewing services performed by them personally as well as for recruiting, training, and assisting interviewers. The interviewers recruited and trained by the area representative are paid directly by you.

7916104

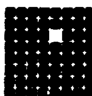
Accepted assignments are performed by the interviewers according to specifications provided initially by you without any further assistance and supervision. The technique of asking probing questions of the interviewers' own design to elicit the proper responses is an essential part of your interviewing procedure. A spot check of the interviews takes place only after all interviews are completed.

In Rev. Rul. 65-183, 1965-2 C.B. 390 the Internal Revenue Service concludes that interviewers who obtain information from the public under the circumstances described in the ruling are not employees. The fact show that the workers are engaged by a corporation on a short-term basis to interview the public, by telephone or in person, and to fill in questionnaire forms reporting the results. The workers are free from supervision or control, and the corporation is interested only in the results reported in completed questionnaires. The workers are paid by the hour or per interview, and they may receive reimbursement for telephone or travel expenses. They are free to refuse an assignment and to work whenever they please subject to the specifications of a particular job. They may engage helpers and are not required to perform the services personally.

In Rev. Rul. 75-243, 1975-1 C.B. 322, the Service illustrates a situation in which interviewers are employees. The distinguishing features from Rev. Rul. 65-183 are that in Rev. Rul. 75-243 the workers are obligated to personally perform the services, are issued specific instructions with respect to conducting the interviews, the type of people to be interviewed, the questions to be asked, and are required to report their progress to the company on a daily basis. Generally, the workers determine where the interviews will be conducted; however, the company retains the right to designate certain areas when it deems such action appropriate. Although the workers do not require constant supervision, the company has retained the right to control and direct the workers to the extent necessary for the satisfactory conduct of its business.

The facts in your case, as stated above, are substantially similar to those in Rev. Rul. 65-183. Therefore, it is our conclusion on the basis of those facts that the interviewers and area representatives are not your employees for purposes of the FICA, FUTA, or Federal income tax withholding.

BEST COPY AVAILABLE



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September 21, 1979

The Honorable Harry F. Byrd, Jr.
Chairman
Committee on Finance
Subcommittee on Taxation and
Debt Management Generally
United States Senate
417 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Byrd:

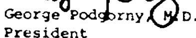
The American College of Emergency Physicians is submitting the attached written comments related to the Subcommittee on Taxation and Debt Management Generally deliberations of S. 736, "The Employment Tax Act of 1979."

We are pleased with the careful review the Subcommittee is giving to the problems being encountered by many as a result of the ambiguity of the classification criteria that has been used by the Internal Revenue Service.

We will appreciate the Subcommittee's consideration of the unique difficulties certain provisions of S. 736 will cause for emergency physicians, as medical professionals have traditionally been considered independent contractors.

If we can be of assistance to you in any way, please do not hesitate to contact us.

Sincerely,



George Podgorny, M.D.
President

GP/mh

Enclosure

1968-1978: ACEP's First Decade of Achievement

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UNITED STATES SENATE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

Written Testimony

submitted by the

AMERICAN COLLEGE OF EMERGENCY PHYSICIANS

concerning

LEGISLATIVE PROPOSALS

RELATING TO INDEPENDENT CONTRACTORS

including

S. 736

September 20, 1979

I

INTRODUCTION

The American College of Emergency Physicians ("ACEP") was founded in 1968 by a group of physicians responding to the growing public demand for improvement in the care and treatment of medical emergencies. ACEP has grown rapidly and now has almost 10,000 members whose primary interest is the support and promotion of excellence in the delivery of emergency medical care.

One of the objectives of ACEP is to foster the working relationships between physicians, physician groups, professional corporations, and hospitals providing emergency department facilities for use by physicians. In particular, we want to encourage and promote the practice of emergency medicine as a full-time specialty. Any governmental proposal which endangers that practice or makes it less attractive or fulfilling may correspondingly portend a decline in availability and quality of emergency care.

There is a continuing need for a concerted national effort to improve emergency medical services, and to encourage and facilitate the practice of emergency medicine. For example:

1. Accidental injury, while on the decline is still the leading cause of death among persons between the ages of 1 and 44 years.

2. Cardiovascular disease is the number two killer in the United States today, accounting for 960,090 deaths in 1977. Of these, nearly one-third, or 305,460, were in the category of sudden death due to heart attack.

3. In 1976, 5,700 deaths were attributed to poisonings and 6,300 deaths were the direct result of serious burn injuries.

We are not pleased with these statistics, but they do reflect an improvement over prior years. Nevertheless, the incidence of unnecessary death and debilitation that can be attributed to inaccessability of appropriate emergency intervention is far too high. This country has the needed knowledge and technology, but it is still not being made uniformly available. Rural hospitals in particular have often lacked for physician coverage of the emergency department and many emergency groups are providing needed emergency coverage for these communities.

The hospitals' ability to contract for emergency department coverage has evolved rapidly over the last 5-7 years and has provided a number of benefits to the health care system. Specifically, it has helped lessen the impact of the maldistribution of physicians, particularly for emergency department coverage in inner city or rural hospitals. At the same time, the quality of care has risen and, we believe, this system has helped keep the cost of emergency care down.

It is essential in expanding the availability and increasing the number of physicians practicing emergency medicine that government regulations do not discriminate against the emergency physician in contrast to other medical specialists. The Internal Revenue Service has recently launched just such an attack, unilaterally attempting to characterize emergency physicians as employees of groups or hospitals where they provide services -- in derogation of the traditional common law concept of the physician as an independent professional responsible to his patients and in disruption of efficient arrangements for delivery of emergency care.

We see this attack as endangering the attractiveness and independence of emergency physicians, casting them in a disadvantaged position compared with other physician specialties.

Such an imposition must be thwarted. We respectfully ask your legislative assistance.

II

BACKGROUND OF RELATIONSHIPS

Emergency physicians have numerous types of working relationships with physician groups and hospitals. These various types of relationships are dictated not only by the preferences of the physicians, but by the needs of the hospitals and the communities they serve. A key advantage is the ability to match availability of the medical doctor to the need of the hospital. These are summarized and simplified as discussed below, although this description is not intended to be a complete analysis of all operating factors. The work relationship frequently takes one of three forms, as illustrated on Chart I, attached.

(i) Some hospitals contract with an individual physician or with a professional corporation owned by a physician or several physicians. The contracting physician or corporation (the "Group") agrees to arrange or coordinate for services of emergency physicians for patients of the hospital, and thereby to provide full-time or intermittent coverage. The Group may, in turn, contract with numerous other physicians directly or with professional corporations that employ physicians to obtain these services.

(ii) Some hospitals use their own employee staff physicians to staff their emergency department, such as military hospitals or certain private closed-group facilities.

(iii) Some hospitals contract directly with each of several physicians to provide services at different times and thus attain full-time coverage of their emergency rooms. These physicians may have their own private office practices in addition to the contracted emergency services or may be residents or interns at other hospitals.

Some emergency physicians by choice negotiate with hospitals or Groups for a working relationship which will be characterized as an employee relationship. These generally do so to attain certain employee fringe benefits. Most, however, have preferred the more traditional independent contractor relationship. The factors described below relate to the independent contractor group.

Compensation patterns for emergency physicians vary. A report prepared by the Department of Health, Education, and Welfare, Health Care Financing Administration, "Study of Reimbursement and Practice Arrangement of Provider-Based Physicians", December 1977, (the "HEW Report"), indicated that 16% of the emergency physicians surveyed billed patients directly for their services. Of the physicians surveyed 26% were compensated directly by the hospital on a salary basis. 19% received compensation based on a percentage of the gross or net fees paid by patients using the emergency department services. This means that 39% of the emergency physicians surveyed were compensated in some other way, many of them using a variation somewhere between the fixed salary approach and the strict fee-for-service approach where the individual physician is paid directly by the patient. These variations are numerous and were not reflected in the HEW report. For example, this report did not distinguish between physicians who contract directly with a hospital for services for patients and physicians who contract with a Group which had contracted with a hospital for patient services. Compensation patterns for physicians providing services to a Group include payment of a percentage of fees generated and payment of hourly fees.

Emergency physicians other than physicians retained as employee staff physicians control the number of hours which they work and the scheduling of their work. Generally, they notify the hospital or the Group in advance to advise it of the time they choose to work for a following week or month, and the shifts that they choose to work, either or both of which may be irregular. They frequently work longer hours than originally anticipated when the emergency department is crowded or patients need additional care. In addition, they generally have the right to change their schedule with little notice.

Independent emergency physicians generally receive no fringe benefits from the hospital or the Group. Physicians who contract directly with hospitals often carry their own malpractice insurance. Physicians who contract with a Group are generally covered by the Group's malpractice insurance policy, although many Groups charge these physicians with each physician's pro rata share of the malpractice insurance premium.

Finally, emergency physicians work independently and with review either by the hospital or the Group (other than review extended to all physicians who are admitted to practice at a hospital) and provide services to patients in the same manner, relationship, and responsibility as does any physician.

III

PROBLEM

No cases have specifically reviewed the common law tests with respect to a physician who provides emergency medical care services in a hospital. In general,

however, most emergency room physicians have relied on Rev. Rul. 66-274, 1966-2 C.B. 446, and similar authorities to support their characterization as independent contractors with the hospital. In that ruling, a hospital contracted with a physician to serve as director of its Department of Pathology. The individual was paid a percentage of fees for his services, was required to pay the remuneration of any physicians that he hired to assist him, and was permitted to perform services for other hospitals. In fact, the individual performed pathology services at three different hospitals. The ruling held that the individual was not an employee of the hospital.

When the Internal Revenue Service started its "purge" of independent contractors in the 1970's, it mounted its attack on physicians in their relationships with hospitals by issuing Rev. Rul. 72-203, 1972-1 C.B. 324 and Rev. Rul. 73-417, 1973-2 C.B. 332. Rev. Rul. 72-203 held that associate physicians working for an independent contractor pathology director were considered employees of the individual pathology director (but not of the hospital). Rev. Rul. 73-417, issued subsequently, however, found the hospital pathology director to be an employee of the hospital -- directly undercutting Rev. Rul. 66-274 by its insinuations of control, rather than by outright reversal. Both rulings reflected an attempt by the Internal Revenue Service to change law and expand its "employee" grip over independent physicians.

More recently and specifically, the Service issued Private Rulings 7833002 and 7804002 which held that certain emergency physicians were employees of the hospitals where they performed services. In the first ruling, the physicians were paid an hourly fee for a fluctuating amount of time which each physician would determine in his own discretion to perform each month and at a time which each physician requested and was agreeable with the hospital. The latter ruling involved contracts with a five-physician group to perform full-time coverage on a percentage fee basis to an emergency room. In neither case did the hospital or its staff provide any control over the manner or means by which the physician performed his services.

This recent Internal Revenue Service attack is contrasted with the result in Azad v. United States, 388 F. 2d 74 (8th Cir. 1968). This case appears to be the court of highest review which has addressed the independent contractor question for physicians. It held that the physician radiologist who managed the Radiology Department of a hospital was not its employee. Neither the hospital nor the doctor regarded each other as an employer-employee. The physician was not restricted to the performance of services solely in that hospital, was not controlled or supervised, did not pay rent to the hospital for its facilities, and was not subjected to hospital rules other than those which applied to all members of the medical staff. The physician was paid by percentage of fees of the Radiology Department.

We believe that Azad is a fair example of the application of common law rules to physicians. Accordingly, the Service is improper in its recent attempts to revise the interpretation of these rules for physicians.

In particular, protection from the Internal Revenue Service's revisions of these rules is needed to clarify that independent physicians who receive compensation based on fees (including hourly fees), control their own hours and scheduling, and are not subject to review of the manner and means of performance of services are independent contractors, both with respect to the hospitals and/or Groups for which they perform services.

IV

PROPOSALS

A. Treasury Proposal.

The Treasury has proposed continued use of the common law test, but with a superimposed requirement that individuals withhold 10% of compensation paid to independent contractors, unless the payment is not made pursuant to a trade or business of the payor, the payee receives payments for similar services from five or more persons, or the payee represents that the 10% withholding would "over withhold" his tax liability. As such, the Treasury's proposal is counter-productive. In the simplest situation, it provides no assurance that an individual physician is an independent contractor. Thus, if the Internal Revenue Service believed that a hospital or Group were "unreasonable" in its determination that an individual was an independent contractor, the hospital or Group would be exposed to substantial retroactive tax liabilities, even if it had withheld the required 10% amount.

How would a hospital know whether it was reasonable or unreasonable? No doubt the hospital would rely on cases such as Azad, supra, to support its reasonable determination that the individual was an independent contractor. The Internal Revenue Service might counter with other arguments (however elusive) to assert that the physician was an employee. Must a hospital continue to be at the mercy of the Internal Revenue Service on this issue -- with all of the administrative cost, disruption, and potential liability which that entails? That is exactly what the retroactive "moratorium" adopted by the Revenue Act of 1978 sought to prevent.

More difficulties arise when a hospital makes payments to a professional corporation Group which manages its emergency department and that Group makes payments to other professional corporations, which, in turn, make payments to individual doctors for work performed. At what level should the 10% amount be withheld? Is multiple withholding required against each level of payment?

Many physicians present a separate bill to their patients either directly or through their hospital's billing service. Would the Internal Revenue Service attempt to characterize these doctors similar to the "direct sellers", thereby requiring them to remit 10% of their patient fees to the hospital to satisfy the purported withholding requirement? Testimony submitted by the Department of the Treasury may indicate that the Service may indeed attempt such an expansive application of the 10% withholding.

Finally, numerous interpretative questions would be difficult to resolve. The concept of "similar services" in the exemption for payments from five payors is ambiguous. Mechanical calculation of the over-withholding exemption will be cumbersome and arbitrary when it is coordinated with the effect of other income, losses, investments, net operating losses, and estimated tax payments which a physician might sustain.

Not only is the Treasury's proposal over-reaching, arbitrary and ambiguous, but it is also unnecessary -- particularly as to physicians. The Treasury's proposal was grounded on the premise that 10% withholding was required for all independent contractors to remedy noncompliance. The Treasury proposal indicates that individuals earning over $50,000 or $100,000 reported 94.6% and 99.9%, respectively, of their compensation. Although no comparative data was included with respect to persons characterized as employees, we assume that this percentage of reported compensation for independent contractors compares favorably with reported compensation for employees. Most physicians are relatively "high bracket" taxpayers. (See HEW Report). Accordingly, the Treasury's proposal imposes burdens on physicians and hospitals without providing any substantial benefit in increased tax collections.

B. S. 736.

S. 736 is helpful in that it attempts to create an objective definition of a working relationship which will be considered an independent contractor relationship. To a large extent, the statutory definition therein can be helpful in assuring physicians of an independent relationship with hospitals and Groups. This intended coverage can be inferred from the background of this legislation that considered physicians as independent contractors. It may create an unintended problem, however, in that its specific language may not clearly cover the physician relationship. The Committee should take this opportunity to insure that the intended result is actually achieved. Toward this end, several of the tests in S. 736 need amplification or amendment to assure that independent physicians will be afforded statutory protection from improper or expansive challenges by the Internal Revenue Service.

1. The first test of independent status (Section (b)(1)) is met if the individual controls the aggregate number of hours actually worked and substantially all of the scheduling of the hours worked. Emergency physicians generally notify hospitals or Groups in advance (weekly or monthly) of the hours that the physician will generally work and what shifts the physician chooses to work for that time period. Frequently, these physicians work longer hours than they originally chose simply because of the volume of patient needs and the physician's own feeling of professional responsibility. Thus, the physicians would satisfy this test. Nevertheless, the Committee reports and explanation of the Bill should indicate that if an individual can periodically choose how many hours he wants to work and when he wants to work them, he will be deemed to satisfy this test of hours and scheduling.

2. The second test (Section (b)(2)) requires that the individual not maintain a principal place of business or, if he does, the principal place of business is not provided by the person for whom services are performed or, if so provided, the individual pays rent therefor. The application of this test to the emergency physician/hospital relationship is unclear. An emergency physician who performs services at a single hospital on a full-time basis (but with control over the aggregate number of actual work hours and scheduling) might be deemed to maintain a principal place of business at the hospital. In fact, however, his services are provided to the public generally, and his professional responsibility runs to his patients. If so construed, the clause would be satisfied, even though the physician did not

pay the hospital rent, since the clause requires the payment of rent only if the principal place of business is obtained from the person to whom service is provided. To reiterate, in this situation the services are provided by the physician for his patients, not the hospital which makes the facilities available.

We are concerned that the Internal Revenue Service may misinterpret this clause in the context of emergency physicians, and deem the hospital as the person for whom services are rendered. Thus, the Internal Revenue Service might argue that these physicians could not satisfy this test, thereby rendering S. 736 ineffective in resolving the employment tax dispute for emergency physicians. Medicare/Medicaid rules, ad valorem tax problems, and industry restrictions prevent most hospitals from allowing emergency physicians to directly pay rent for the facilities. Moreover, it would be contrary to industry practice for a hospital to charge physicians for the use of its facilities. That charge is in fact borne by patients.

Accordingly, to provide substantive relief for emergency physicians, this Committee should indicate that patients will be deemed the persons for whom services are performed, notwithstanding that the services are performed in an emergency department of a hospital and pursuant to contractual arrangements with a hospital for the performance of services for patients.

3. The third and last substantive test (Section (b)(3)) requires either that the individual have a substantial investment in assets used in connection with the performance of the service or that the individual be remunerated in a manner directly related to sales or other output, rather than the number of hours actually worked. Although this test may have originally contemplated an investment in tangible assets, it should be extended as well to substantial investments in intangible assets. A physician's sizable investment in costs and time of a professional education is as meaningful an investment as another individual's investment in tangible equipment. Moreover, the Income Tax Regulations recognize that a specific professional education is an asset which is, in part, capital in nature. Treas. Reg. §1.162-5(b). Since a physician's education and training requires a substantial investment in both time and money, physicians should be deemed to satisfy the investment test and the Committee's report should so indicate.

Most emergency physicians clearly satisfy the alternative income fluctuation test in Section (b)(3), since their remuneration is either direct patient fees or a percentage of fees collected for the physicians by the hospital or Group. Other emergency physicians, similar to other professionals, calculate their fees on a simple hourly rate and bill hospitals or Groups a fee based on hours of service rendered. Since such a negotiated fee for professional hours worked would, in fact, be related to that physician's "sales or other output" and would correspond with industry practice for many, if not most, professionals, such a compensation arrangement should satisfy the income fluctuation criteria. Accordingly, the Committee should indicate in its report that the prohibition in this test of payment based on the "number of hours actually worked" should not apply to professionals who are normally remunerated for services performed based on a fee for hours worked.

V

SUMMARY OF SOLUTIONS

As indicated above, S. 736 can be used as a basis for solving the dilemma of hospitals, Groups, and emergency physicians, but it will require clarification to insure that Congress' intent is not thwarted by the Internal Revenue Service's zeal to characterize individuals as employees. The clarifications necessary have been noted above, but are summarized here for review and evaluation:

1. The Committee should oppose -- or at least deal cautiously -- with the proposed mandatory withholding for independent contractors. In particular, it should require an exemption from such withholding if the payee anticipates adjusted gross income of $35,000 or more for the year.

2. The Committee should emphasize that the hours and scheduling test will be satisfied if the worker can periodically choose how many hours he works and when he works them.

3. The Committee should emphasize that a physician or professional corporation will be considered performing services for patients, notwithstanding that the physician or professional corporation, either directly or through other physicians or professional corporations, might have contracted with a hospital to perform services for these patients without payment of rent to the hospital for use of its facilities.

4. The Committee should illustrate the substantial investment in assets test by reference to a physician's investment in time and money for professional education and training.

5. The income fluctuation test, which requires remuneration to be related to sales or other output "rather than to the number of hours actually worked", should be modified by explanation or amendment to indicate that this test will be satisfied if the "output" is professional services and if industry practice would normally remunerate a professional on an hourly fee basis.

6. We urge that S. 736 be amended to assure independent contractor status if the worker meets 4 of the 5 prescribed tests, rather than requiring him to meet all of the tests. This would insure that personnel such as emergency physicians, intended to be classified as independent contractors, were not misclassified because of a technicality in the statute. A "preponderance" test would provide a more workable solution to finalizing the status of individuals, and would prevent the unwarranted Internal Revenue Service attack on work relationships.

7. Alternatively, an additional sixth test could be added that an individual must obtain a license from a professional association or governmental agency to render the services involved, and the statute modified to require that an individual meet 5 of the 6 tests to be considered an independent contractor. Use of a license as an optional statutory test of an independent contractor is appropriate since it identifies those persons who have generally received special training and who generally have particular individual responsibility for their work performed.

8. Finally, and most simply, Congress could assure independent contractor status to physicians by adding a clause to S. 736 to specify that physicians, substantially all of whose services involve treating patients in private offices or in hospitals or clinics, shall be deemed independent contractors if their services are performed pursuant to a written contract which specifies independent contractor status.

VI

CONCLUSION

The preservation of the independent contractor status of emergency physicians is critical to continuing improvements and advancements in emergency care. It is key for several reasons:

1. To make these physicians employees will only add to the cost of health care. For example, if emergency physicians who work with numerous hospitals were considered employees of the hospitals, each hospital would pay the FICA tax on that physician -- resulting in a multiplication of the social security taxes paid on that physician over the amount of self employment tax he would have paid as an independent contractor. This excess cost is undoubtedly passed on to the public as increased health care costs.

2. Characterization of these physicians as employees would interfere with the traditional role of the physician and is a threat to the independent judgment of the physician.

In summary, the doctor/patient relationship has traditionally been a paradigm of independent contractor relationship. S. 736, as originally drafted, made no attempt to define statutorily this relationship as independent, since it was presumably assumed that the Internal Revenue Service would recognize the relationship as an independent contractor relationship.

We understand the scope and significance of the issues which the Committee must now confront structuring a fair and equitable tax system which overlays a complex and changing society involves difficult line-drawing. Perhaps for these very reasons, we are particularly aware of the unique physician/patient relationship which has existed for centuries, and the paramount responsibilities which stem from that relationship. We desire to insure and protect the right of physicians, including those in emergency health care, to maintain that relationship -- professionals whose responsibilities to their patients are their own.

Notwithstanding all the dialogue about simplification, the Treasury Department seems willing to embark upon a course that will likely make an already complex and overburdened tax system even more so.

We urge that this Committee maintain the independence of the emergency physicians and the quality of services they perform by rejecting the Treasury Department proposals and by adopting legislation comparable to S. 736 with the clarifications suggested in this statement.

We are grateful to the Committee for this opportunity to be a part of this important legislative process.

TYPICAL RELATIONSHIPS
BETWEEN
HOSPITALS AND EMERGENCY ROOM PHYSICIANS

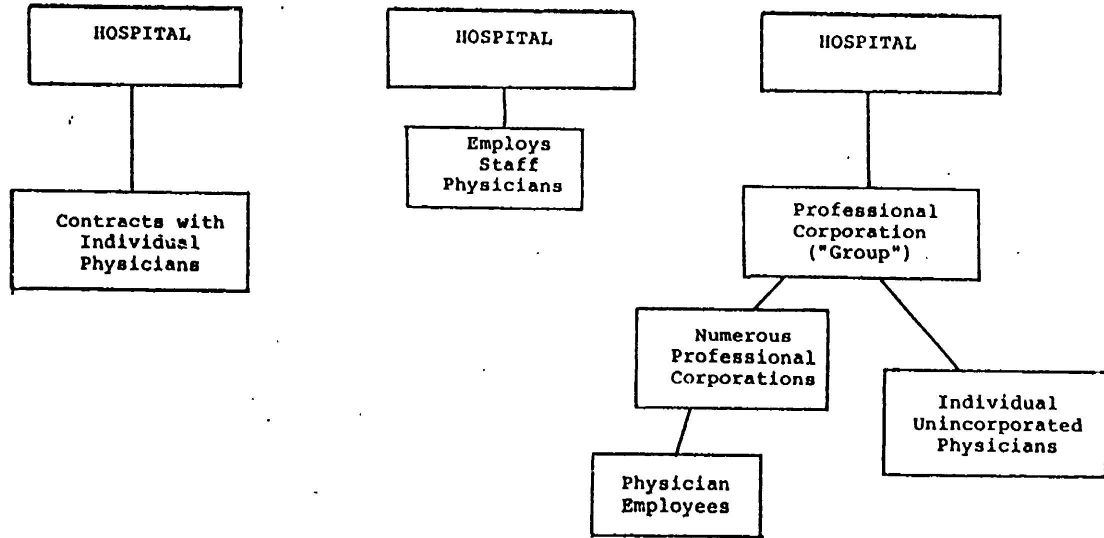

CHART I

Recommended Language Changes and Clarifications
Related to Provisions in

H.R. 3245 "Independent Contractor Tax Status Clarification Act of 1979"

submitted by the
American College of Emergency Physicians

We suggest that the following change be made:

(b) REQUIREMENTS - For purposes of subsection (a), the requirements of this subsection are met with respect to service performed by any individual if *four of the following five conditions are met.*

In the subcommittee's report under discussion of paragraph (b)(1) CONTROL OF HOURS WORKED, we suggest that the following paragraph of clarification be included:

"...Because some services must be made available without interruption during a given period of time and those persons responsible for insuring that this service is available without interruption need prior commitment from contractors of their intentions to be available at specific times, this test is satisfied if an individual contractor can periodically, perhaps on a weekly or monthly basis, indicate how many hours he or she wants to work and when this work will be performed."

In the subcommittee's report under discussion of paragraph (b)(2) PLACE OF BUSINESS, we suggest that the following paragraph of clarification be included:

"...The Committee recognizes that the independence of the relationship between the physician and his or her patient has been traditionally regarded as inviolable. Even though some physician services are regularly provided in one location such as a hospital, and the hospital sometimes serves as the billing agent for the physicians, it is not the Committee's intent that the hospital be construed as the person for whom the physician services are performed. When provided by a physician, medical services are performed for the patient without regard to the location where those services are performed.

In the subcommittee's report under discussion of paragraph (b)(3) INVESTMENT OR INCOME FLUCTUATION (A) "Investment in Assets", we suggest that the following paragraph of clarification be included:

"...Assets are generally considered the tangible facilities or equipment used by workers in performing given responsibilities. The Committee recognizes that in the preparation for some professions, such as law and medicine, there is a substantial investment in the intangible asset of training and education that must be made before the professional can legally perform services. The Committee considers this training and education to be an asset in the terms of this section. Therefore, these professionals will be deemed to satisfy the investment in assets test."

In the subcommittee's report under discussion of paragraph (b)(3) INVESTMENT OR INCOME FLUCTUATION (B) "Income Fluctuation", we suggest that the following paragraph of clarification be included:

"...Many professionals, after a review of their experience of the charges for service, have developed hourly equivalents as a matter of convenience and practicality. The committee's intention is that the prohibition against payment of charges calculated by the number of hours actually worked should not apply to professionals who are at times remunerated on this basis."

STATEMENT OF
COLONIAL LIFE AND ACCIDENT INSURANCE COMPANY
SUBMITTED TO
THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE.
SEPTEMBER 17, 1979

Background

Colonial Life and Accident Insurance Company (the Company) is a corporation organized under the laws of the state of South Carolina with its principal place of business located in Columbia, South Carolina. The Company has been engaged in the life and accident insurance business for approximately forty years and its insurance products are sold in most of the fifty states.

The Company's products are sold through a distribution system of independent sales representatives which is relatively common in the insurance industry. Some of the representatives are "agents" and sell primarily products developed by the Company. Other representatives are "brokers" and sell products developed by a number of companies. Still other representatives have supervisory functions over agents in addition to their own sales functions. All of the representatives are compensated by commissions, based strictly on production. In addition, and depending on the level of production, representatives may be eligible for various prizes, including automobiles and trips. All of the representatives are responsible for maintaining their own place of business and appropriate licenses, and are responsible for their own expenses.

Although some of the representatives have been affiliated with the Company for a number of years, the Company experiences a fairly high rate of turnover and some representatives are affiliated with the Company for only a few weeks at the time. Some of the representatives work essentially full-time; others may maintain totally distinct businesses in addition to marketing the Company's insurance products. All representatives are retained under written agreements which provide that the relationship with the Company is that of principal-independent contractor, and which specify that the Company shall have no direction or control over the time or activities of the representative. The Company files appropriate information returns with the Internal Revenue Service and provides copies of such returns to its representatives.

For sound business reasons, the Company utilizes independent contractors as opposed to employees to perform the sales function. The Company has found, through years of experience, that insurance sales personnel work best when they have freedom to operate with independence and when their activities are motivated by incentive as opposed to directive. In the Company's view, individual initiative and individual responsibility are primary determinants of an effective sales force. The Company is proud of the representatives associated with it, and the representatives are proud of their independence.

Prior to 1975, the Company had been audited by the Internal Revenue Service (IRS) on various occasions with no question ever raised as to the status of its representatives

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as independent contractors. The Company has always carefully monitored IRS rulings and cases to assure compliance with technicalities required to maintain the principal-independent contractor status.

During 1975, the IRS began an audit of the Company and ultimately determined that supervisory sales representatives of the Company were in fact employees. At the same time, the IRS made a factual finding that soliciting agents and brokers representing the Company were in fact independent contractors. Based on its determination, the IRS subsequently proposed an assessment of several million dollars against the Company, consisting of alleged deficiencies in withholding taxes, FICA taxes, and FUTA taxes. The assessment was made despite the fact that the Company had not changed its method of operation or its relationship with representatives since prior audits, and despite the fact that the Company carefully complied with existing IRS rulings and cases. In fact, the IRS had changed <u>its</u> position and had applied this changed position retroactively. Ultimately, the IRS conceded the case against the Company as a result of passage of Section 530 of the Revenue Act of 1978.

During January of 1979, the Company became aware that many of its representatives were the subject of audit by the IRS. On inquiry, the Company learned that the audits were the result of a survey or study being undertaken by the IRS in an effort to determine the tax compliance levels of independent contractors. The Company requested, under the

Freedom of Information Act, substantial information regarding the study. The request was denied with the exception of some instructional pages out of an Internal Revenue Manual Supplement. The information provided was of absolutely no use to the Company in determining either the methodology of the survey or the results of the survey as to representatives associated with it.

Based on its own analysis of information provided by a substantial number of representatives, the Company has reason to believe that the compliance rates of representatives associated with it are excellent. Indeed, the survey undertaken by the IRS itself indicates a high level of compliance by independent contractors within the insurance industry at large.

The IRS Study

During late 1978 and 1979, the IRS conducted a study in an attempt to determine levels of compliance of workers that it had reclassified as employees. The IRS has placed great weight on the results of that study and contends that the results are a convincing factor in support of drastically expanded withholding requirements.

We strongly question the findings of the study.

The sample selected by the IRS was unweighted, and we question whether it was representative of the universe of independent contractors. Furthermore, the sample drew no correlation between compliance levels of various categories of independent contractors and the "safe harbor" factors of S.736 and H.R. 3245, and we strongly question whether it is representative of compliance levels which could be anticipated for contractors qualifying under the "safe harbor" test. Even assuming that the IRS compliance figures are statistically sound, we are aware of nothing in the study which establishes that non-withholding is the cause of low compliance or that greatly expanded withholding is the cure. Specifically, it appears that no comparative surveys were conducted to determine if the fact of withholding or non-withholding is really the critical factor in compliance levels of various taxpayers. For example, we are aware that some insurance companies, by choice and for their own reasons, use employees as opposed to independent contractors in their sales forces. We would be interested in a comparison of compliance rates

of self-employed agents with those of employed agents. Furthermore, it may be that withholding requirements are not the primary determining factor in levels of compliance, but rather income level is. It is noteworthy that a cursory examination of the exhibits submitted by the Administration at the June 20, 1979 hearings before the Select Revenue Measures Subcommittee of the House Ways and Means Committee would support this theory (See Chart No. 2). It may also be that preparation of information returns (e.g., Forms 1099, W-2) is the determining factor. The Company, for example, has always provided Forms 1099 to its representatives, as, we believe, many insurance companies have. This may well account for the high level of compliance by independent contractors in the insurance industry.

In summary, we question not only the results of the IRS survey, but also the ultimate conclusion drawn from the survey by the IRS that the key determinant of high compliance levels is withholding.

<u>The Administration's Proposal</u>

Based primarily on its conclusions regarding compliance levels, the Administration has proposed major changes in the withholding requirements for independent contractors, including the imposition of substantially increased responsibilities on payors.

The Administration, specifically, has proposed that a flat rate of 10% be withheld from payments made in the course of a trade or business for services provided by an independent contractor. Exceptions would permit individuals who work for five or more payors, or who would be overwithheld, to elect out of the system. The existing common law test would be maintained for purposes of determining who is an employee as opposed to an independent contractor, although the Administration has indicated that it would agree to a more objective standard (if such standard classified a sufficient number of workers as employees). In the case of reclassification of workers, payors would be liable for a penalty of 10% of the amount of wages not withheld on, plus FUTA taxes, plus the employer's share of FICA taxes. The penalty tax would be abated if it were "reasonable" for the payor to treat the worker as an independent contractor and if the payor had withheld the 10% flat rate (or where the worker had elected out of the system). It should be noted that if the payor acted "unreasonably," the 10% penalty would be in addition to the 10% flat rate already withheld. If the payor had not withheld any amount, apparently the

law existing prior to passage of Section 530 of the Revenue Act of 1978 would continue to apply.

The Administration has further proposed that information reporting requirements be strengthened. Specifically, the penalties for failure to file information returns would be increased, copies of information returns would be required to be provided to workers, and the information return requirements would be extended to "buy-sell" situations.

The Administration, finally, has suggested that consideration be given in the future to increasing SECA tax rates relative to FICA tax rates to bring the two into parity.

As an alternative to its primary proposal, the Administration has proposed replacing the common law test, and requiring normal graduated rate withholding on all workers unless such worker had 1) a separate place of business (other than a home office); 2) a substantial investment in assets (other than transportation vehicles used in a non-transportation business); 3) employees of his or her own who provided a substantial portion of the services for which compensation is received; or 4) substantial continuing expenses and concurrently performed services for more than one payor. (We are uncertain as to whether the four tests are conjunctive or disjunctive; we assume they are disjunctive.)

From analysis of its two proposals, it is evident that the Administration is concerned simply with maximizing withholding to the extent politically feasible since it has determined that withholding equates with higher compliance.

Although withholding by definition assists with high collection levels, we question - as noted previously - whether withholding is really the primary determinant of high compliance levels. We are inclined to believe that information reporting to the IRS, coupled with fear of audit, are the more important factors.

We also contend that there are principles other than individual compliance levels which are entitled to consideration in determining whether to expand withholding requirements. For example, we would place weight on the right of free people to enter into contractual relationships defining their respective rights and obligations. We would place weight on the principle that individuals are responsible for their own actions and for payment of their own taxes. We would place weight on the principle that individual initiative and responsibility should be encouraged. As a general matter we contend that the desires and burdens of the public, as opposed to the particular desires and burdens of professional tax collectors, are entitled to special consideration under our form of government. Furthermore, we contend that if the Government desires to further intrude on the lives and affairs of its citizens, it has the burden of proving that such intrusion is necessary and justified. We do not believe the Government has carried its burden in this particular matter.

The Administration has proposed a fundamental change in the tax responsibilities of principals and independent contractors which can have far-reaching implications. We do not

believe a change of this magnitude is appropriate, much less necessary, to accomplish the desired purpose of higher compliance levels.

We urge this Subcommittee to reject the Administration's proposal and to adopt a proposal - specifically S.736/H.R. 3245 - which retains the traditional rights and responsibilities of principals and independent contractors, while at the same time resolving past uncertainties and encouraging higher individual compliance through strengthened information reporting requirements and existing audit tools of the IRS.

S.736/H.R. 3245

S.736/H.R. 3245 is an attempt to legislatively codify the fundamental elements of the common law test of *respondeat superior* and thus avoid for the future the uncertainty and the unfairness of the common law test *as it has been applied by the IRS in recent years*.

The essence of the common law test is exercise of control or right to control a worker as to the details and means by which a particular job is performed. The test is an expression of the principle that if an individual exercises sufficient control over another individual, the former, as a matter of social policy, should have responsibility for actions of the latter while the latter is subject to that control. Contrary to the assertion of the Administration, these common law principles of *control* and *responsibility* are entirely appropriate in the tax context. If an individual controls the work done by another, controls the income and

expenses in connection with that work, and controls the payment for that work, then it is not unreasonable to place responsibility on the former to withhold funds to meet the latter's obligations to the Government. On the other hand, if parties have specifically contracted away the element of control, if a worker works at his or her own pace and schedule and is responsible for his or her own expenses and production of income, then we contend that it is inappropriate to impose the responsibility for withholding on the payor.

The withholding tax system came into being as a result of the Current Tax Payment Act of 1943. At the time of passage, the Congress "found it impracticable to apply the withholding provisions to income other than wages..." Sen. Rept. 221, 78th Con., 1st. Sess., 1943 C.B. 1314, 1319. We contend that this finding continues to be valid for reasons including (1) the inequity of overwithholding where a worker's income fluctuates depending on his or her own efforts and expenses, (2) the administrative costs connected with withholding, and (3) the inappropriateness of placing responsibility on a payor who does not have the appropriate degree of control over a worker and over the worker's production of taxable income.

We note that the Administration's alternative proposal is not unlike S.736/H.R. 3245 in concept. It would provide a "safe harbor" test for independent contractor status based upon objective facts. However, the Administration's alternative "objective factors" do not focus on elements of control, or

on the appropriateness of a payor's responsibility, but rather on indications of wealth and economic substance of the worker. We do not believe these latter criteria are appropriate.

For example, with respect to "maintaining a place of business", whether or not a worker works out of the home would appear to be of little relevance in determining the appropriateness of placing withholding responsibility on a payor. In our judgment, this factor would be of relevance only if the payor provided the principle place of business for the worker without cost to the worker. Similarly, the Administration's exclusion of transportation vehicles from the "substantial investment and assets test" appears convenient to the IRS desires, rather than relevant to the issue of responsibility for withholding. Automobiles often constitute a very substantial investment, and are in fact critical in some businesses, particularly the insurance and other sales businesses where the product must be "carried" to the customer. The appropriate consideration in this connection would appear to be whether or not a transportation vehicle is in fact used in the worker's business, and whether such vehicle is provided at the worker's own expense or is provided at the expense of the payor.

The "presence or absence of employees retained by the worker" is relevant to the withholding issue, but alone does not determine whether or not a worker may have a fluctuating income, a risk of loss, and a taxable income substantially

less than gross amounts paid by a payor. "Substantial continuing expenses" is a relevant factor, although if the purpose of this test is to identify workers with fluctuating incomes and a risk of loss, it would appear that the tests could be better stated in the more direct fashion.

In summary, the Administration's alternative proposal appears to be little more than a limitation of the provisions of S.736/H.R. 3245 in an effort to exclude the maximum number of workers from the status of independent contractor. It is not an attempt to address the fundamental issue of responsibility, and the appropriateness of placing that responsibility on a particular payor. S.736/H.R. 3245 does represent such an attempt, and we contend that it succeeds.

Administrative Burdens and Estimated Costs of Compliance With the Administration's Proposal

The Company has analyzed the Administration's primary proposal and alternative proposal with a view to determining the anticipated administrative burdens which would have to be assumed by the Company if the proposals were implemented, as well as the anticipated costs of such compliance.

The Administration's proposals would extend the Company's withholding requirements to some 1800 to 2000 representatives. The Company estimates a cost of over $30,000 to initially implement the system changes required under the Administration's primary proposal and over $80,000 to initially implement changes under the alternative proposal. These estimates include consideration of computer program design, installation and implementation; modification of commission compensation systems; modification of master control files; and coordination with current payroll systems. The system operating charges are estimated to be over $18,000 per year. In addition, it is estimated that 3 to 5 employees would have to be hired for the new work under either proposal. The additional salaries, plus mailing, printing, and other overhead expenses would range between $40,000 to $50,000 per year. Under the Administration's primary proposal the Company would have no increase in additional FICA or FUTA taxes. Under the Administration's alternative proposal, the Company would have an annual liability for additional FICA and FUTA taxes (based on 1979 FICA rates of 6.13% on $22,900) of some $700,000 to $800,000.

The Company estimates the income potentially earned from "float" under the Administration's primary proposal at less thatn $7,000 per year. There is no doubt that either of the Administration's proposals would impose substantial costs on the Company.

Along with the financial costs noted above, there would be associated problems in administering the new withholding system. Due to the high turnover rate of insurance representatives, simply keeping up with withholding documents would present an administrative problem. Unlike the Company's home office employees, many times a sales representative is retained by the Company but only produces for three to four weeks before terminating. Assuming withholding would be calculated on a monthly or quarterly basis, this could many times leave the Company with no cash due the agent to deduct the withholding amount from. Furthermore, due to the independent nature of the Company's representatives, a representative could in fact no longer be soliciting business for the Company and the Company not know it for several weeks.

The communication between the Company's home office and the representatives relative to the various documents which would have to be signed before withholdings could take effect would be difficult since the representatives do not physically work on the home office premises. The representatives travel a great deal and are difficult to contact. Often the Company has insufficient addresses or telephone information on representatives until several weeks after they begin producing business.

Additional withholding problems would arise with respect to compensation paid to representatives in kind. For example, automobiles and trips are awarded frequently for outstanding production and are reported for information and tax payment purposes. However, withholding on such items would be very difficult.

Some of these administrative difficulties may appear insignificant at first glance. However, they are real, they involve time, and they epitomize the type of real world problems and "red-tape" that businesses face - and that tax collectors too often ignore - when new tax requirements are proposed.

When the administrative costs and burdens of complying with the Administration's proposals are compared with the relatively small amount of taxes which would be withheld, it is indeed questionable if the assumed benefits to the Treasury justify the actual costs to the public.

Conclusion

The Company submits that S.736/H.R. 3245 would adequately protect the interests of all concerned and would accomplish the desired purposes. It would restore certainty to the area of employee-independent contractor status determinations. It would identify specific criteria which if met would negate "payor control" and thus negate the appropriateness of "payor responsibility". It would require the provision of information which would encourage compliance. It would require that independent contractors be specifically advised of their employment tax obligations.

We urge this Subcommittee to recommend enactment of S.736/H.R. 3245 as the comprehensive and permanent solution to the problem of employee-independent contractor status determinations. However, if the Congress should determine that it cannot enact a permanent and prospective solution to the problem this year, then we urge that the relief provisions of Section 530 of the Revenue Act of 1978 be extended until the final solution is concluded.

Telegram

WAB015(1337)(1-023145A256)PD 09/13/79 1335
ICS IPMSFSD SFO
24100 SANFRANCISCO CA 113 09-13 1056A PDT
PMS MR MICHAEL STERN DLR
STAFF DIRECTOR
SENATE COMMITTEE ON FINANCE
2227 DIRKSEN SENATE OFFICE BLDG (MUST BE DELIVERED BEFORE 5PM
HAND)

WASHINGTON DC 20510
THIS IS TO EXPRESS OUR SUPPORT FOR SENATE BILL 1514 WHICH WILL
BE HEARD BY THE SUBCOMMITEE ON TAX AND DEBT MANAGEMENT ON
SEPTEMBER 17
SANITARY FILL COMPANY AND THE CITY AND COUNTY OF SAN FRANCISCO
ARE SPONSORING CONSTRUCTION AND OPERATION OF A 35 MEGAWATT
POWER PLANT TO BE FUELED BY PROCESSED MUNICIPAL WASTE. IT IS

SF-1201 (R5-69)

Telegram

CONTEMPLATED THAT THE PROJECT WILL BE FUNDED BY BONDS OF THE
CALIFORNIA POLLUTION CONTROL FINANCING AUTHORITY AND APPROVAL OF
SENATE BILL 1514 WOULD BE OF SUBSTANTIAL ASSISTANCE IN
EXPEDITING SUCH FINANCING.
WE URGE THE SUBCOMMITTEE'S FAVORABLE ACTION AND WOULD
APPRECIATE THE INCLUSION OF THIS STATEMENT OF SUPPORT
IN THE RECORD
LEONARD STEFANELLI
PRESIDENT
SANITARY FILL COMPANY
503 TUNNEL AVENUE
SAN FRANCISCO CALIF

NNNN

SF-1201 (R5-69)

BEST COPY AVAILABLE

The National
Small Business
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1604 K Street, N.W.
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STATEMENT OF THE

SMALL BUSINESS LEGISLATIVE COUNCIL

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HOLDING HEARINGS ON

S. 736

CLARIFYING THE TAX STATUS OF INDEPENDENT CONTRACTORS

September 17, 1979

"It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise..."

(P.L. 85-536, as amended, Section 2(a), Small Business Act.)

*Of the National Small Business Association

STATEMENT OF THE
SMALL BUSINESS LEGISLATIVE COUNCIL
BEFORE THE
SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HOLDING HEARINGS ON
S. 736
CLARIFYING THE TAX STATUS OF INDEPENDENT CONTRACTORS

The Small Business Legislative Council is an organization of over 70 national trade and professional associations and their affiliates representing over 4 million small businesses throughout the country.

Independent contractors are an integral part of the small business community which the SBLC represents. The status of the independent contractor is essential if individual entrepreneurship and small business is to flourish in this country. The reclassification of independent contractors as employees is anti-small business with an adverse effect on the job market, as well as causing an adverse effect on anti-inflation efforts by increasing costs of doing business and reducing competition. For this reason SBLC supported the interim relief granted to taxpayers in Section 530 of the Revenue Act of 1978, and now lends its full support to S. 736, the bill sponsored by Senator Robert Dole. The 48 member associations of the Small Business Legislative Council supporting S. 736 are listed on Attachment A to this statement.

Prior to the legislative action taken by the Congress last year, the Internal Revenue Service had initiated a campaign in some areas of the country to challenge and alter the tax status of small business people filing as independent contractors. Despite repeated defeats in the courts and sharp criticism from the GAO, the IRS had increased pressure for changes in the basic make-up of the industries utilizing this status -- that is, the

reclassification of the independent contractors from small business people to employees of companies. The major motivations of the IRS in justifying reclassification appeared to be a desire to correct alleged under-reporting of income by independent contractors, to bolster the Social Security trust fund by changing from a self-employed payment system to a FICA system, and to provide unemployment compensation to these individuals.

The Treasury Department supported the position of the IRS and considered radically revamping the requirements one must meet to be classified as an independent contractor. The changes then proposed could have effectively eliminated millions of small business careers throughout the country.

The SBLC recognized then, as it does now, the need for workable and definitive criteria for independent contractor status. This is especially true in light of the expiration at the end of this year of Section 530, the interim solution adopted by Congress last year. Continued uncertainty in this area can have a negative impact on growth of industries to which the use of independent contractors is critical. The impact will be most harshly felt by smaller companies which do not have the flexibility or finances to restructure a marketing force or their whole way of doing business.

The SBLC has formally adopted the position, supported by 48 associations, that the independent contractor is an integral part of our economy and is essential if individual entrepreneurship and small business is to flourish in this country. The reclassification of independent contractors as employees would be anti-small business, with an adverse effect on the job market, as well as causing an adverse effect on anti-inflation efforts

by increasing costs of doing business and reducing competition. The SBLC supports legislative initiatives such as S. 736 to clarify the status of independent contractors for employment tax purposes.

S. 736 provides a necessary safe harbor test, and retains for the millions of small businesspeople operating under it, the common-law test. The bill provides certainty for those industries where IRS has attempted to reclassify independent contractors and would preserve status of those small businesspeople who have historically been treated as independent contractors.

Most significant, though, is the bill's five-pronged test for safe harbor protection. Where the following five criteria are not fully met, the common-law test definition of an employee would be applied. The independent contractor: (1) controls number of hours worked; (2) is not provided with a place of business by the person for whom services are performed; (3) has complete freedom in capital investment and income; (4) signs a written contract stating tax responsibilities, and (5) files required returns with the Internal Revenue Service.

These five criteria provide the legislative mandate necessary to clarify who is an independent contractor. And in those cases where not all tests are met, the tax status will be judged by common-law tests. Small businesses utilizing independent contractors and independent contractors themselves will benefit immeasurably from the certainty that this legislation provides. Moreover, the requirement of written contracts and notification to independent contractors of tax responsibilities, and the requirement of filing informational returns as intended by the bill will

give both IRS and independent contractors additional information to improve tax compliance.

In hearings held by the House Subcommittee on Select Revenue Measures June 20, the Administration proposed that a flat rate of 10 percent be withheld from payments made in the course of a trade or business for services provided by an independent contractor. In reviewing this proposal, the SBLC has noted that it is conceptually inconsistent with the philosophy and purpose of the independent contractor -- that is, being truly independent, "one's own boss." We cannot emphasize enough the importance of this incentive to entrepreneurial initiative.

Also, the Administration's proposal is so broad that traditional buy-sell, franchise, or selective distribution arrangements could be required to withhold taxes, when in fact the companies impacted have nothing from which to withhold. Furthermore, since Treasury has indicated that withholding would be based on suggested resale price of merchandise resold by the independent contractor, there is serious question as to whether this would be an indirect pressure on the independent contractor to indeed sell at the suggested price. Such pressure, of course, is in direct contravention of the purpose of the antitrust laws.

In addition, SBLC has serious reservations about the Treasury proposal because of the administrative costs involved in withholding. Institution and maintenance of recordkeeping, changes in accounting systems, etc., especially in industries where the independent contractor enters and leaves the industry frequently, could be burdensome, particularly for smaller companies that have very little ability to absorb such costs.

These increased costs could also result in some industries phasing out part-time, low earning individuals in order to balance increased costs to companies for administering a withholding program. The withholding proposal, by increasing costs and paperwork, runs counter to Administration assertions that it would reduce these kinds of burdens for small business.

# # #

ATTACHMENT A

The National
Small Business
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Telephone
(202) 296-7400

September 17, 1979

The position paper -- Tax Status of Independent Contractors -- is supported, as of this date, by 48 members of the Small Business Legislative Council.

American Association of Nurserymen
Washington, D.C.

American Textile Machinery Association
Washington, D.C.

Association of Diesel Specialists
Kansas City, Missouri

Association of Physical Fitness Centers
Bethesda, Maryland

Automotive Warehouse Distributors Association
Kansas City, Missouri

Building Service Contractors Association International
McLean, Virginia

Business Advertising Council
Cincinnati, Ohio

Christian Booksellers Association
Colorado Springs, Colorado

Direct Selling Association
Washington, D. C.

Eastern Manufacturers and Importers Exhibit, Inc.
New York, New York

Electronic Representatives Association
Chicago, Illinois

Furniture Rental Association of America
Washington, D. C.

Independent Bakers Association
Washington, D. C.

Independent Business Association of Washington
Bellevue, Washington

Independent Sewing Machine Dealers of America
Hilliard, Ohio

International Franchise Association
Washington, D. C.

Institute of Certified Business Counselors
Lafayette, California

Local and Short Haul Carriers National Conference
Washington, D. C.

Machinery Dealers National Association
Silver Spring, Maryland

Manufacturers Agents National Association
Irvine, California

Marking Device Association
Evanston, Illinois

-more-

*Of the National Small Business Association

National Association for Child Development & Education
Washington, D. C.

National Association of Brick Distributors
McLean, Virginia

National Association of Floor Covering Distributors
Chicago, Illinois

National Association of Home Builders
Washington, D. C.

National Association of Plastics Distributors
Jaffrey Center, New Hampshire

National Association of Realtors
Chicago, Illinois

National Association of Retail Druggists
Washington, D. C.

National Beer Wholesalers' Association of America
Falls Church, Virginia

National Burglar & Fire Alarm Association
Washington, D. C.

National Candy Wholesalers Association
Washington, D. C.

National Electrical Contractors Association
Washington, D. C.

National Family Business Council
West Bloomfield, Michigan

National Home Furnishings Association
Washington, D. C.

National Home Improvement Council
Washington, D. C.

National Independent Dairies Association
Washington, D. C.

National Office Machine Dealers Association
Zanesville, Ohio

National Office Products Association
Alexandria, Virginia

National Paper Trade Association
New York, New York

National Parking Association
Washington, D. C.

National Patent Council
Arlington, Virginia

National Pest Control Association
Vienna, Virginia

National Small Business Association
Washington, D. C.

National Society of Public Accountants
Washington, D. C.

National Tire Dealers & Retreaders Association
Washington, D. C.

National Tool, Die & Precision Machining Association
Washington, D. C.

Printing Industries of America
Arlington, Virginia

Sheet Metal & Air Conditioning Contractors Association
Vienna, Virginia

TAX STATUS OF INDEPENDENT CONTRACTORS

The IRS has initiated a campaign to alter the tax status of small businesspersons filing as independent contractors.

Despite repeated defeats in the courts and sharp criticism from the General Accounting Office, the IRS has increased pressure for changes in the basic make-up of the industries utilizing this status -- that is, the reclassification of independent contractors from small businesspersons to employees of corporations. The major motivations of the IRS in justifying reclassification appear to be a desire to correct alleged under-reporting of income by independent contractors, to bolster the Social Security trust fund by changing from a SECA payment system to a FICA system, and to provide unemployment compensation to these individuals.

The Treasury Department has seen fit to support the IRS position and has considered radically revamping the requirements one must meet to be classified as an independent businessperson to avoid tax burdens not presently levied. These proposed changes, if adopted by Congress, could effectively eliminate millions of small business careers throughout the nation.

The Revenue Act of 1978 provides interim relief from employment tax liability to taxpayers involved in employment tax status controversies. Eligible taxpayers are relieved of all liability for federal income tax withholding, Social Security (FICA) taxes, and unemployment (FUTA) taxes with respect to their workers for any period ending before January 1, 1979, provided the taxpayers had a reasonable basis for not treating the workers as employees. To minimize taxpayers' uncertainty about the proper treatment of workers for employment tax purposes during 1979, the bill also relieves taxpayers prospectively through December 31, 1979, of potential liabilities based on employment status classifications, unless the taxpayers have no reasonable basis for not treating the workers as employees. The bill also prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling with respect to individuals' employment tax status after enactment of this legislation and before January 1, 1980, or the effective date of any legislation clarifying the employment tax status of individuals, whichever is earlier.

RESOLVED

The independent contractor status is an integral part of our economy and is essential if individual entrepreneurship and small business is to flourish in the country. The reclassification of independent contractors as employees would be anti-small business, with an adverse

effect on the job market,as well as causing an adverse effect on anti-inflation efforts by increasing costs of doing business and reducing competition. We support a legislative initiative to permanently implement recommendations of the Conference Report on the Tax Reform Act of 1976, prohibiting the IRS from applying any new or changed position in this area, inconsistent with a general audit position, regulation, or ruling in effect on January 1, 1976.

# # #

STATEMENT

OF THE

NATIONAL RETAIL MERCHANTS ASSOCIATION

BEFORE THE

TAXATION SUBCOMMITTEE

OF THE

SENATE FINANCE COMMITTEE

ON

S. 224, TAXATION OF EMPLOYEE FRINGE BENEFITS

SEPTEMBER 17, 1979

This statement is submitted today on behalf of the National Retail Merchants Association, a nonprofit trade association representing over 35,000 leading department, chain and specialty stores. The aggregate annual sales volume of NRMA's members is in excess of $95 billion and they employ more than 2.5 million workers.

NRMA's comments are directed solely to one of the bills which this Subcommittee is considering, namely S. 224, legislation to prohibit permanently the issuance of regulations on the taxation of employee fringe benefits. The general merchandise retail industry is concerned in particular with one of the many existing employee fringe benefits -- employee discounts, the practice of allowing retail employees and others to purchase the employer's merchandise at a discount from the regular selling price.

NRMA believes that employee discounts should not be considered as compensation taxable to the employee. We agree, of course,

that an employee should be taxed on what he or she earns by performing services -- generally, on his or her wages. But employee discounts differ from wages in a fundamental way. Wages are clearly compensatory and are intended to be remuneration for services; employee discounts, on the other hand, are not intended as compensation, and they are not viewed by our employees as payment for services. Indeed, the value of the discount to any individual employee depends on how much he purchases, and not on how valuable his services are to his employer. In point of fact, retailers make employee discounts available for two purposes that are entirely separate and distinct from compensation: first, to stimulate the company's sales to a natural group of consumers that might not otherwise buy as much of the company's merchandise; and second, to enable employees to become familiar with, and to wear and be seen in, the merchandise they are selling.

It is important to understand a crucial fact about employee discounts -- the employer makes a profit on sales to employees. The discounted price is rarely, if ever, less than the employer's cost. By offering employees a discount, a company increases its overall sales as well as its profits, which are subject to the regular corporate income tax. The economic reasoning behind discounts is evident in the practice of some of our members of providing discounts to persons who are not, strictly speaking, employees -- for example, the surviving spouses of longtime company employees, retired employees, the clergy, boy and girl scouts. Employee discounts are a way for the retailer to reach a natural group of customers whose extensive patronage he might not otherwise obtain.

The second reason why retailers provide discounts to employees is to help stimulate sales to the general public. Retailers have found that persons who have had personal experience with the store's merchandise make more effective salespersons; their morale is higher, and they are often more loyal advocates of their employer and his goods. This rationale applies not only to salespersons but to other employees as well. For example, an assistant buyer's friends or neighbors naturally will expect him to have patronized his employer, and will look to him for his opinions regarding his employer's merchandise; it would hardly be to the employer's advantage if such an employee had no knowledge of the merchandise he was responsible for.

In addition, many retailers have found that having salespersons wear and display the apparel that is available at the store is an effective means of advertising -- it makes good business sense for a customer to see a salesperson in the store wearing that store's apparel. It would be hard to make a salesperson believe that he had taxable income as a result of making an expenditure that was to his employer's benefit, and where one of the reasons he purchased his employer's merchandise was to be more effective in doing his job. The discount serves exactly the same purpose as an employee business expense that is reimbursed by the employer.

Most employees would not believe, and would find it quite difficult to understand, that their employee discounts represent a form of taxable compensation. Indeed the Internal Revenue Service for decades has taken the same attitude. (See Treas. Reg. §§31.3401 (a)-1 (b) (10) (income tax withholding), 31.3121(a)-1(f)(FICA), and 31.3306(b)-1(f)(FUTA).) We believe that most employees view employee

discounts like other kinds of "benefits" that employees enjoy but that are not considered compensation. Like other nontaxable benefits, the employee discount is intended to, and does, promote the health, good will, contentment and efficiency of his employees -- purposes which, under present law, are recognized as exempting these benefits from employment taxes.

From the compliance point of view, taxing employee discounts also makes little sense. In the vast majority of cases, a discount reduces the price of a single purchase by only a few cents or dollars. The cost of accounting for a large number of employee sales on a separate basis, each small in amount, will greatly burden the limited resources of the employer. This additional cost will be particularly burdensome in the case of a small retailer who does not have access to sohphisticated computer systems or large accounting firms. We question whether any revenue gain resulting from taxing employee discounts is worth the additional social costs of compliance -- especially when a tax on the discount will discourage employee purchases.

NRMA also believes that a rule of law designed to tax employee discounts would raise administrative problems of very great complexity. The most difficult problem would be the valuation of the discount for inclusion in the tax base. Treasury spokesmen have commented that the only workable policy would be a tax based on objective fair market value. (See Statement of Donald S. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Task Force on Employee Fringe Benefits, Committee on Ways and Means, August 14, 1978.) But the objective dollar value of the discount

simply does not accurately measure its real value. For example, a sales clerk at a department stores may purchase his employer's merchandise at a 10 percent discount; comparable merchandise may be available at a promotional sale at a store around the corner at the same or even lower price. It is difficult in this case to find the bargain that is being taxed, for the employee has purchased the merchandise at one of its many fair market values. There is as much taxable income to an employee who buys merchandise using his employee discount as there is to a member of the general public who buys merchandise at a 20 percent markdown during a January white sale.

Even where the merchandise is not otherwise available, there would be grave problems with a policy that made a so-called bargain into taxable income. An employee is under no compulsion to purchase goods at his employer's store; if he does so, it is only because the price that he pays is equal to the value of the goods to him. In other words, he gets just what he pays for, without any element of taxable compensation or income.

NRMA wishes to emphasize, however, that the employee discounts utilized in the retail industry do not involve transfers of property to employees at unreasonably low cost. The retail employee discount enables the employer to increase sales and thus taxable profits while at the same time obtaining a measure of advertising services plus a more educated sales force, and promoting the goodwill, contentment and efficiency of his employees. The consistent administrative practice of the Treasury over many decades has been not to view employee discounts as compensation, and we believe that that view represents a correct policy for today.

We greatly appreciate this opportunity to express our views.

STATEMENT OF STANLEY C. SIMON
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY, SENATE FINANCE COMMITTEE, ON LEGISLATIVE PROPOSALS
RELATING TO "INDEPENDENT CONTRACTORS"

My name is Stanley C. Simon. I am an attorney. My firm name is Simon & Twombly, and my office is located at Two Turtle Creek Village, Dallas, Texas 75219. I am making this statement on behalf of The Southland Corporation, which supports S. 736.

Southland is engaged in several businesses; the largest one is 7-Eleven Stores. There are almost 7,000 7-Eleven Stores. Most of them are in the United States, but they are also located in -- at last count -- 7 foreign countries.

Over 3,000 of the American 7-Eleven Stores are franchised. This makes Southland one of the largest franchisors in the country, from the standpoint of number of franchisees. Some 7-Eleven franchisees are corporations or partnerships; most are married couples; some are individuals.

The store agreements between Southland and the franchisees generally provide for a term of 15 years or, if less, the remaining term of the lease to Southland of the store. Southland can only terminate a franchise for a breach specified in the store agreements. Typical breaches are bankruptcy, abandonment of the store, impairment of Southland's security interest, which I will describe in a minute, and failure to maintain an independent contractor relationship with Southland.

A franchisee pays Southland a franchise fee of $10,000 and a continuing 7-Eleven charge which is a percentage of his gross income. He usually buys his initial inventory from Southland.

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He pays at least $7,500 on the inventory and borrows the balance from Southland at interest; the loan is secured by the inventory.

Southland furnishes the franchisees with recommended vendors and suggested retail price lists; the franchisee buys whatever he thinks will sell from whomever he wishes and fixes his own retail prices. He is required to report all purchases and retail prices to Southland so that it can provide the contracted bookkeeping service -- and calculate its 7-Eleven charge.

For the percentage of gross income, a franchisee receives a package, turnkey deal from Southland -- the use of the land, building, and equipment, merchandising advice, the use of the service mark and trademark "7-Eleven," bookkeeping service, some mass media advertising, and indemnification against certain losses -- those that it would be too costly for 3,000 plus franchisees to buy separate insurance coverage; group casualty insurance is not available under the laws of many states.

In order to protect its national image, Southland insists that each 7-Eleven Store be open at least from 7 A.M. to 11 P.M., every day of the year except Christmas. In order to encourage franchisees to keep their stores open longer hours, Southland reduces the 7-Eleven charge if a store is open 20 hours a day, and reduces it even more if it is open 24 hours a day.

This does not mean, however, that the franchisee is required to work any particular hours. He hires whatever employees he wants and fixes their hours. His own hours, if any, are fixed by him. I know a franchisee in Phoenix who is a full time practicing lawyer; he only comes into his store to buy beer.

Besides paying Southland the 7-Eleven charge, the franchisee has to pay operating expenses, such as payroll, payroll taxes and insurance, inventory variation, supplies, telephone, equipment repairs, janitorial, general maintenance, laundry, business licenses, permits and bonds, inventory and business taxes. returned checks, interest expense, and miscellaneous expense.

When the franchisee buys merchandise for sale or pays expenses, he approves the voucher or payroll and forwards it to Southland, which pays the approved items and adds the amount to the loan I described earlier. As is customary in financing like this, sales proceeds are deposited daily in an account designated by Southland; they reduce the loan.

The franchisee draws an agreed amount each week for his own living expenses. Each quarter 70% of the franchisee's increase in worth must be applied to reduce the loan. He may draw the other 30% or leave it in to reduce the interest on the loan. After the loan is paid off, the franchisee draws his entire net profits every month.

Southland furnishes the franchisee with an income statement and balance sheet every month, as well as a product movement analysis. Southland's computer generates the accounting entries at the same time that it records deposits of sales receipts and pays expenses for the franchisee. Southland also prepares all tax returns, except income tax returns, for the franchisee's signature.

A franchisee's profits fluctuate every month in accordance with his sales, cost of goods sold, and expenses. Some franchisees make profits of $60,000 or $80,000 per year; others lose

money. Some even go broke.

A franchisee is free to sell his franchise to anyone who meets Southland's criteria for franchisees. In this case, he is paid for his inventory, any equipment he may have bought, and any premium attributable to the fact that the store is unusually profitable or the fact that the percentage of gross profits specified as Southland's 7-Eleven charge is higher in current store agreements than it was in earlier agreements. One store here in Washington sold for $80,000 good will plus the value of the inventory; a California store sold for $125,000 good will.

The Internal Revenue Service has ruled that 7-Eleven Store franchisees are not employees of Southland; they are independent contractors, independent businessmen. A copy of that ruling is attached to this statement.

The same question has arisen in other contexts, with the same result. The National Labor Relations Board has ruled that 7-Eleven Store franchisees are not employees of Southland under Federal labor law. The Arizona courts have held that 7-Eleven Store franchisees are not Southland employees for Workmen's Compensation purposes. The Arizona Employment Security Commission has determined that Southland's franchisees are in an independently established business, not its employees. Similar rulings have been obtained from the Nevada Industrial Commission, the California Unemployment Insurance Appeals Board, the California Workmen's Compensation Appeals Board, the New York Department of Labor, the Connecticut Unemployment Compensation Department, and the Joint Reporting Committee of the Equal Employment Opportunity Com-

mission. The Circuit Court for Prince George's County of Maryland and the Corporation Counsel to the Commissioners of the District of Columbia reached the same result in the context of the laws prohibiting chain stores and multiple alcoholic beverage licenses, respectively.

S. 736 would continue the result previously reached by the Internal Revenue Service, that is, it would make it clear that 7-Eleven Store franchisees are not employees of Southland. The only modification Southland suggests is that there be added at the end of the first sentence of proposed section 3508(a)(2) ", whether or not separately stated." This would make it clear that the rent paid by a 7-Eleven Store franchisee through the 7-Eleven charge qualifies, even though the charge is not broken down into separate percentages for each of the items it covers.

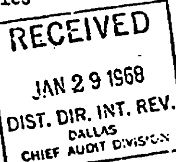
UNITED STATES GOVERNMENT

Memorandum

TO : District Director
Dallas, Texas

DATE: JAN 25 1968

FROM : National Office, Internal Revenue Service



SUBJECT: The Southland Corporation
2823 North Haskell Avenue
Dallas, Texas 75204
and
Mr. Larry R. Martin
5574 Ora Drive
San Jose, California

This is in reply to your memorandum of July 28 and 31, 1967, furnishing information for a ruling relative to the status, for Federal employment tax purposes, of Mr. Larry R. Martin while operating a retail grocery store under an agreement with The Southland Corporation, doing business as "Speedee Mart", hereinafter referred to as "Speedee" from July 3, 1965 to the middle of January 1967.

Speedee has devised a system for the operation of convenience-type food markets. Mr. Martin entered into an agreement with Speedee, a copy of which was enclosed, under which Speedee granted to Mr. Martin the right and license to use the "Speedee Mart" system and trade name and the right and license to use all "Speedee Mart" trademarks, labels and copyrights, as well as any advertising media which were the property of, or which might be developed by, Speedee.

The agreement provided that Speedee would lease the real property and all the equipment used in the operation of the market to Mr. Martin. The equipment consisted of a cash register, adding machine, stationery, and business forms. The trade fixtures were at all times the sole property of Speedee. A charge of 14.4% on sales and miscellaneous income was to be made by Speedee as rental for the real property and trade fixtures and for services to be performed by Speedee.

Mr. Martin agreed to adhere to Speedee's plans and directions as to location of trade fixtures, inventory, special displays, signs and advertising, and to purchase and offer for sale only those items authorized by Speedee and in the amounts and brands approved by Speedee, beer and wine excepted. Mr. Martin was to maintain at all times an adequate inventory of not less than $10,500, wholesale cost, this being the amount of the inventory when he took over the operation of the store. In addition, Mr. Martin was required to pay to Speedee $1,600 as a security deposit on the lease of the real property and the trade fixtures and to deposit approximately $500 to provide working capital for the cash register fund,

Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

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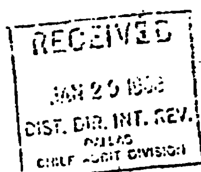

DD:Dallas -2-

In re: The Southland Corporation
and
Mr. Larry R. Martin

business license and miscellaneous items. Upon execution of the agreement Mr. Martin was to pay Speedee $3,000 in cash against the total obligations stated in the agreement for the various considerations of the agreement. The unpaid balance represented an open current account due and payable to Speedee. The open current account was to be charged with all disbursements made by Speedee for Mr. Martin and credited with all receipts deposited by Mr. Martin in the authorized bank. Any unpaid balance at the commencement of any accounting period would be subject to a quarterly interest charge of 2 1/2%.

The agreement (including the sublease of real property and the trade fixtures) could be terminated six months after the date of the agreement by either party upon giving a 30-day written notice within five days after the delivery by Speedee of the periodic financial statements.

The information furnished to you, and forwarded to us, is that Speedee required Mr. Martin to attend a one week course of training at its training school and upon completion of the course furnished him with its manual of standard operating procedures which comprehensively set forth the operating routines he should follow.

Mr. Martin contends that he was Speedee's employee. He states Speedee specified that the store was to be open from 7:00 a.m. to 11:00 p.m., seven days a week, and he was required to see that those hours were observed. He states that he was required to follow Speedee's standard operating procedures and that a field supervisor came to the store at least once a week to inspect the premises for cleanliness, to see that the prices were right, that the window signs were up, that the specials were on sale and that no unauthorized items were on sale.

As an integral, and essential, part of its arrangement with Mr. Martin and as called for in the agreement, Speedee provided a complete accounting service. For this purpose Mr. Martin was required to deposit, on designated days but at least three times a week, in a bank designated by Speedee, money equal to all sales made to the date of deposit for credit to the current account carried in the store's name and to mail the receipted duplicate deposit tickets to Speedee on specified days. On Saturday of each week Mr. Martin mailed to Speedee all invoices for merchandise purchased during the week and Speedee paid them, as well as the expenses of operating the store, from the current bank account.

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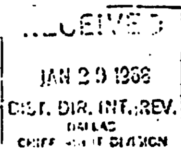

In re: The Southland Corporation
and
Mr. Larry R. Martin

As noted above, Mr. Martin was responsible for keeping the store open during the hours specified by Speedee but it was within his discretion whether he would hire helpers to assist him in maintaining the open hours, how many he would hire and what hours they would work. Mr. Martin did, in fact, hire helpers and returns on Form 941 were prepared with respect to them by Speedee.

Mr. Martin was paid on the basis of sales. Increase of sales meant higher income. If sales were maintained at a certain level for the entire year, he received a guaranteed amount of remuneration. Mr. Martin was given a weekly drawing account of $150 provided certain conditions were met. Bonuses were paid if the sales exceeded certain amounts.

The store was operated under Speedee's trade name and Speedee did, or furnished, all advertising. Mr. Martin did not hold himself out to the public individually by telephone directory listing or otherwise. However, all necessary city, State and Federal licenses were issued in Mr. Martin's name and at his expense.

Speedee contends that Mr. Martin did not have the status of an employee and, as is our practice where an employer-employee determination is involved, we invited it to submit and explain the grounds for its position.

Basically, Speedee maintains that its relationship with Mr. Martin was that of franchisor-franchisee and lessor-lessee; that under the agreement for Mr. Martin's services he obtained the use of certain of its valuable franchise properties, such as trademarks, trade name, national good will, etc., as well as establishing a creditor-debtor relationship; and that apart from being subject only to the degree of control by Speedee legally necessary to protect its franchise rights, Mr. Martin was free to operate the store as he saw fit.

It is pointed out that while Speedee controlled the hours and days when the store was to open, this is a factor of its national good will franchise image and it did not have the right to require Mr. Martin personally to work those, or any, hours or days. He was free to hire helpers if he wished to do so, and, thus, he himself decided how many hours he would work, if any.

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RECEIVED
JAN 29 1968
DIST. DIR. INT. REV.
DALLAS
FIELD AUDIT DIVISION

In re: The Southland Corporation
and
Mr. Larry R. Martin

Speedee states that the principal purpose of having its field representatives visit its franchise stores, its obligation under the agreement, is to offer advice and suggestions to the store operators concerning their operating methods, to inform them of any new methods that may have been developed, to try to help them with any problems they may have encountered, and to urge them to run their stores as outlined in the operating manual. It emphasizes, however, that the representatives act purely in an advisory capacity, that they cannot, as a matter of right, require a store operator to adopt any suggestion but, instead, it is optional with every operator, including Mr. Martin, whether they will follow any suggestion. Similarly, Speedee recommended inventory items and retail prices as guidelines but, if he wished to do so, Mr. Martin disregarded these recommendations.

Speedee would not allow Mr. Martin to disregard its requirements relative to banking the store receipts and forwarding the deposit tickets and invoices of purchases to it at stated regular intervals. It points out, however, adherence to this requirement was necessary if it was to provide the orderly accounting service it had obligated itself to furnish to Mr. Martin.

It also is pointed out that Mr. Martin received all of the income from his store from the sale of merchandise and paid all operating expenses, including the equipment rental charge. Consequently, the net constituted his profit, or loss, and represented both compensation for his labor and his return on his investment.

In spite of the conflict of opinion between Speedee and Mr. Martin, it seems to us the statements of both establish that Mr. Martin operated the store under a franchise agreement and he procured all business licenses, etc., required by governmental authorities in his name. He had an investment in the business and its success depended in large part on his own initiative, judgment and energy. He hired and supervised his own assistants, who were paid from his share of the receipts. He also had other expenses. These factors indicate an element of risk of profit or loss which is almost never present in an employment relationship. It is true that under the contract, Speedee retained certain controls over the store operations to protect its trademark and property. However, it is the total situation, including the risk undertaken, the control exercised,

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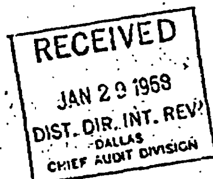
In re: The Southland Corporation
and
Mr. Larry R. Martin

the opportunity for profit from sound management, that mark Mr. Martin as an independent contractor. Accordingly, we conclude that for Federal employment tax purposes, including income tax withholding, Speedee did not exercise or have the right to exercise over Mr. Martin in the performance of the services in question the degree of direction and control necessary under the usual common law rules to establish an employer-employee relationship.

Our conclusion may be applied to the case of any other individual operating a store under a franchise agreement with The Southland Corporation, provided the facts and circumstances do not differ in any material respect from those in the case of Mr. Martin.

END



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STATEMENT
OF
NATIONAL HOME IMPROVEMENT COUNCIL
BEFORE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
HEARINGS ON
S. 736
LEGISLATIVE PROPOSALS RELATED TO INDEPENDENT CONTRACTORS
SEPTEMBER 17, 1979

National Home Improvement Council (NHIC) is a trade association serving the home improvement and remodeling industry. Its membership is just over 3,000: divided into national and local members. Our 60 national members are predominantly manufacturers of material and equipment used in the industry, and include the shelter and trade publications. Our local membership is basically found in the 44 NHIC chapters in major market areas across America. The largest portion of our membership is in the contractor community in these local chapters.

Various industry studies show differing figures for the number and type of home improvement contractors in the country. The likelihood is that the number is in excess of 40,000 contractors who are generalists in the remodeling, room addition and general home improvement business or who are roofing/siding specialists, kitchen/bath remodelers or insulation contractors. Industry studies show that the average remodeler employs 8 or 9 full-time employees and 2 or 3 part-time. By virtually every applicable federal definition of "small business," the home improvement contractor is included in that definition.

The largest single grouping of home improvement contractors throughout the country is the small entrepreneurial organization that specializes in skilled craftsmanship in a general home addition, home improvement business with an average of 2 or 3 employees. These units employ people with similar skills and backgrounds. The typical contractor has little if any accounting or business background. He depends essentially on 20 or more separate types of craft specialists or independent

subcontractors: the electrical contractor, the sheet metal specialist, the roofer, the brick mason, et cetera. These skilled craftsmen, in their turn, are fiercely independent. They prize their entrepreneurial status and do not wish to be designated as "employee." The general contractor cannot exist without these special skills.

Section 530 of the Revenue Act of 1978 was much appreciated by the small business community in America. It recognized that the definition of "employee" in the tax statutes left something to be desired, and afforded an opportunity for IRS harrassment. This industry was especially hard hit. Many of us received claims of the Federal Government for so-called back taxes, penalties and interest of amounts in the 6 and 7 figures -- totals that would in almost every instance wipe out our business if the government seriously attempted to collect. And in almost every instance the claim was based on our utilization of independent contractors and the attempt by the government to characterize these entrepreneurs as our "employees."

The contractors of our industry very much appreciate the approach of the Dole Bill, S. 736, and heartily endorse the "safe harbor" test as offering the opportunity for the small businessman to have some degree of assurance that by meeting the five-point test, he will be free of IRS harrassment. At the same time, we welcome the reaffirmation by Congress of the traditional common-law test for those who have been historically treated as independent contractors.

Our small businessmen, already deeply awash in the regulatory requests of ERISA, the insulation rules, DOE and FTC, would find it very, very difficult to set up any complicated withholding system as proposed by the recent IRS testimony in these hearings. There really are no accounting departments or tax officers operating for the small Mom and Pop type of contractor in our business. To require

withholding by the contractor for "independent contractors" would impose an intolerable burden. I respectfully hope that your Committee would see fit to oppose that suggestion by IRS.

Finally, we would also hope that your Committee, Mr. Chairman, would see fit not to recommend an increase in the self-employed tax structure from the current 8 percent to 12 percent. A 50 percent increase in this tax on top of the already contemplated changes in the social security tax structure would be an economic blow of substantial proportion to the already hurting small business community.

I very much appreciate this opportunity to appear before this Subcommittee and to register the wholehearted support of our industry for S. 736, the bill under consideration. If there are any questions, I will be more than happy to respond.

NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

1717 Pennsylvania Avenue, N.W., Washington, D.C. 20006
Phone (202) 298-9040

Office of the Federal Taxation Committee Chairman
Elmer F. Heckinger
561 Maitland Avenue
Altamonte Springs, Florida 32701
(305) 830-0858

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Stanley H. Stearman
Washington, D.C.

September 24, 1979

The Honorable Harry F. Byrd
Chairman
Subcommittee on Taxation and
Debt Management Generally
Room 2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Chairman:

This is to express the National Society of Public Accountant's strong opposition to the Department of Treasury's position with regard to the taxation of income earned by independent contractors.

NSPA's 17,000 independent accountants in public practice provide auditing, accounting, tax and management advisory services to 10 million taxpaying clients (3 million of which are small business).

We believe that any change in the existing tax policy with regard to independent contractors will significantly increase costs and expenses which will feed inflation and increase prices to the consumers.

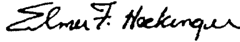
NSPA feels the position of the IRS is unreasonable and without justification. The implication that independent contractors are willful tax evaders is contrary to the basic tenants of the American voluntary tax system.

In addition to adding unnecessary additional costs and expenses for independent contractors (who are primarily small business and who can ill afford to absorb such additional costs), the Treasury Department proposal would require the employer to know or verify the fact that a prospective independent contractor had more or less than 5 employees. This could render the employer unnecessarily liable for the representations of the independent contractor, be difficult for the contractor to control at any given time and is not "job related" in the sense that it does not relate directly to whether or not the independent contractor can successfully perform the contracted for task.

I have attached for your review and consideration some recommendations in this area which we received from one of our members. However, it is not necessarily the recommendations of the National Society.

Based on the foregoing, NSPA supports the provisions of H.R. 3245 as being a reasonable approach to the situation.

Sincerely,



Elmer F. Heckinger
Chairman
Federal Taxation Committee

EFH:phm
attachment

1. Employers:

   a. Strict adherence to obtaining a Social Security Number and home address from all Independent Contractors.

   b. Issuance of Form 1099's to independent contractors with the same deadline date as for current issuance of W/2's, with Reconciliations to the Social Security Administration.

2. Independent Contractors:

   a. Same responsibility for obtaining Form 1099 from employer as in current situation of employees obtaining W/2's.

   b. Inclusion of copy of Form 1099 by all receipients on their Form 1040. Same procedure as currently in use by W/2 receipients.

3. Internal Revenue Service:

   a. Change current Form 1099 from 3 copies to 4 or 5 copies so that independent contractor would have additional copy to attach to their Form 1040 with 1040 requirement to attach same, as in case of current W/2's.

   b. Change on current Form 1040 that would indicate total remuneration received on Forms 1099 (current Form 1040, line 11 or 20 could easily handle this inclusion).

   c. Inclusion of additional line on current Schedule SE that would indicate remuneration received on Form 1099 (current Line 5d of Part II also could be changed to conform to same).

   d. Institute matching program of Form 1099's received to amounts reported (same as current W/2 matching program).

CITY OF CHESAPEAKE

CHESAPEAKE, VIRGINIA

ARIAN P. WHITEHURST
MAYOR

September 12, 1979

Honorable Harry F. Byrd, Jr.
Sub-Committee of Taxation and Debt Management
Generally
Senate Finance Committee
417 Senate Office Building
Washington, D. C. 20515

Dear Senator Byrd:

I have been advised that you have a Public Hearing scheduled for the week of September 17, 1979, on Senate Bill 1514, and would like to endorse passage by the Congress of this particular bill.

The passage of Senate Bill 1514 is very necessary in order for the Southeastern Public Service Authority Solid Waste to Energy Project to be undertaken successfully.

With warmest regards,

Sincerely,

(Mrs.) Marian P. Whitehurst

ow

Chamber of Commerce of the United States of America

Washington

September 10, 1979

TO: MEMBERS OF THE SENATE COMMITTEE ON FINANCE

FROM: Hilton Davis
Vice President, Legislative Action HD

SUBJECT: Revenue Effects of Decontrol

On August 2, 1979, the staff of the Joint Committee on Taxation, the Department of Treasury, and other interested persons were requested to supply the Senate Finance Committee with estimates of the amount of revenue that decontrol of crude oil prices and adoption of a "windfall profits" tax would raise. The attached charts show the amount of revenue that the Chamber of Commerce of the United States estimates would result (1) from decontrol alone, and (2) from decontrol with a "windfall profits" tax.

I. Effects of Decontrol

The National Chamber believes that decontrol should result in a substantial increase in the overall level of economic activity. This finding is contrary to assertions made by the Treasury Department on August 2. The Chamber estimates that decontrol alone should raise real GNP by an average of $13 billion per year (in 1979 dollars) between 1980 and 1990, an increase of 0.4 percent. Decontrol should increase industrial production by 0.6 percent and create an extra 300,000 jobs over this same period. Increased domestic production resulting from decontrol should reduce oil imports and thus strengthen the dollar, improving our trade position by an average of $21 billion per year.

The net increase in federal receipts due to the increased economic activity from decontrol with no "windfall profits" tax will be more than $194 billion between 1980 and 1990, even if there are no real oil price increases over the next decade. (State and local government receipts will also be higher, by more than $25 billion.) The net increase in federal receipts is derived from the following factors:

(1) As a result of oil price decontrol, oil producers and royalty holders will pay an additional $140.3 billion in income taxes between 1980 and 1990. The federal government will also receive $9 billion in increased royalty payments over this period.

(2) Increased production in the non-oil producing sectors of the economy should increase federal revenue by $11 billion. Decontrol also will lead to a modest increase in the rate of inflation and to higher prices in the first half of the next decade. But by 1986 to 1990, the increase in the inflation rate due to decontrol will not be significant. The resulting higher general price level, however, will increase the dollar value of federal revenues. This should add over $68 billion to federal tax receipts. Thus the increased production in the non-oil sectors and the higher general prices will increase federal revenue by $79.8 billion over the next decade.

(3) The increased economic activity, however, will increase the costs of goods purchased by the government. These higher costs will offset somewhat the increase in revenue from oil producers, non-oil producers and higher general prices. During the 1980 to 1990 period, the increased costs will be $34.7 billion.

The growth of federal receipts resulting from decontrol will be even larger if the real price of imported oil increases. For example, if world oil prices rise by 3 percent per year in real terms between now and 1990, federal tax receipts from oil producers and royalty holders alone would increase to over $197 billion over the next decade: federal royalty receipts would increase to $11 billion: and federal income tax receipts from the non-oil producing sectors of the economy should increase by $185 billion. This will come partially from increased economic activity and partially from increased inflation caused by the higher oil prices.

II. Effects of "Windfall Profits" Tax

The enactment of a "windfall profits" tax on domestic oil production would severely reduce the benefits of oil price decontrol and would have an adverse impact on the entire U.S. economy. Even if no further increases in the real price of imported oil occur, the House version of the "windfall profits" tax will result in a net decrease in oil producers' income of $101.8 billion between 1980 and 1990. This reduction in funds available for investment would reduce domestic oil production by 800,000 barrels per day by 1990. Loss of domestic oil production would result in lower investment, higher unemployment, l wer domestic non-oil production, and a potentially larger trade deficit. Real GNP in constant 1979 dollars would be almost $5 billion per year lower between 1980 and 1990 as a result of the "windfall profits" tax, a decrease of .16 percent. The "windfall profits" tax also would reduce employment by almost 114,000 jobs, increase the unemployment rate by 0.1 percentage points, and drop industrial production by nearly 0.4 percentage points over the same period.

The decline in production in both the oil and non-oil producing sectors of the economy due to the imposition of the "windfall profits" tax would cause federal government tax receipts from non-oil sources to decrease. This would partially offset the added receipts coming to the federal government from the "windfall profits" tax. These offsetting reductions in federal individual and corporate income taxes and social security tax receipts could total $15 billion over the next decade.

The National Chamber will be glad to supply additional information or background material concerning these calculations. We certainly hope that this material will prove helpful to the Finance Committee in its deliberations on this important issue.

TABLE A

Effect of Oil Price Decontrol
Without "Windfall Profits" Tax
No Real Oil Price Increase
(Current $ billions)

	1980	1981	1982	1983	1984	1965	Totals 1980-85	Totals 1986-90	Totals 1980-90
Increase in Income Tax on Oil Producers	3.0	8.5	12.0	12.4	13.1	14.0	63.0	77.3	140.3
Plus Increase in Federal Income Tax on Non-Oil Producers	-	1.0	2.0	3.4	7.6	9.3	23.3	56.5	79.8
Plus Increase in Federal Royalties	0.2	0.5	0.6	0.7	0.8	0.9	3.7	5.4	9.1
Less Increase in Current Dollar Government Expenditure Necessary to Maintain Level of Real Government Expenditure	-	0.9	2.6	3.5	3.6	3.9	14.5	20.2	34.7
Equals Total in current dollars	3.2	9.1	12.0	13.0	17.9	20.3	75.5	119.0	194.5

SOURCE: U.S. Chamber of Commerce, Forecast and Survey Center.

TABLE B

Effect of Oil Price Decontrol
With "Windfall Profit" Tax
No Real Oil Price Increase
(Current $ billions)

	1980	1981	1982	1983	1984	1985	Totals 1980-85	1986-90	1980-90
Increase in Federal Income Tax on Oil Producers (Excluding deduction for WPT)	2.7	8.0	10.6	10.7	11.0	11.3	54.3	57.0	111.3
Plus Increase in Federal Income Tax on Non-Oil Producers	-	0.6	1.6	2.8	6.7	8.1	19.8	45.0	64.8
Plus Increase in Federal Royalties	0.2	0.5	0.6	0.7	0.8	0.9	3.7	5.4	9.1
Plus Net Receipts From Windfall Profits Tax	2.6	8.1	11.3	11.5	12.1	12.8	58.4	72.4	130.8
Less Increase in Current Dollar Government Spending Necessary to Maintain Level of Real Government Spending	-	0.9	2.6	3.5	3.6	3.9	14.5	20.2	34.7
Equals Total in current dollars	5.5	16.3	21.5	22.2	27.0	29.2	121.7	159.6	281.3

SOURCE: U.S. Chamber of Commerce, Forecast and Survey Center.

TABLE C

Effect of Oil Price Decontrol
Without "Windfall Profits" Tax
3% Real Oil Price Increase
(Current $ billions)

	1980	1981	1982	1983	1984	1985	Totals 1980-85	Totals 1986-90	Totals 1980-90
Increase in Federal Income Tax on Oil Producers	3.4	9.7	14.1	15.4	17.1	19.2	78.9	118.8	197.7
Plus Federal Income Tax on Non-Oil Producers	0.5	4.0	7.3	11.8	16.3	18.9	58.8	126.1	184.9
Plus Increase in Federal Royalties	0.2	0.5	0.7	0.8	0.9	1.0	4.1	6.9	11.0
Less Increase in Current Dollar Government Spending Necessary to Maintain Level of Real Government Spending	0.5	1.5	3.7	5.8	8.2	10.3	30.0	57.1	87.1
Equals Total in current dollars	3.6	12.7	18.4	22.2	26.1	28.8	111.8	194.7	306.5

SOURCE: U.S. Chamber of Commerce, Forecast and Survey Center.

TABLE D

Effect of Oil Price Decontrol
With "Windfall Profit" Tax
3% Real Oil Price Increase
(Current $ billions)

	1980	1981	1982	1983	1984	1985	Totals 1980-85	1986-90	1980-90
Increase in Federal Income Tax on Oil Producers (excluding deduction for WPT)	3.0	8.4	11.8	12.4	13.4	14.3	63.3	85.7	149.0
Plus Increase in Federal Income Tax on Non-Oil Producers	0.5	3.6	6.9	11.2	15.4	17.7	55.2	114.6	169.8
Plus Increase in Federal Royalties	.2	.5	.7	.8	.9	1.0	4.1	6.9	11.0
Plus Net Windfall Profit Taxes	3.1	9.0	12.8	13.8	15.2	16.8	70.7	109.7	180.4
Less Increase in Current Dollar Government Spending Necessary to Maintain Level of Real Government Spending	0.5	1.2	3.4	5.5	7.9	9.9	28.4	57.1	85.5
Equals Total in current dollars	6.3	20.4	28.9	32.7	37.0	39.9	164.9	259.8	424.7

SOURCE: U.S. Chamber of Commerce, Forecast and Survey Center.

STATEMENT

OF

AMERICAN MOVERS CONFERENCE

INTRODUCTION

We appreciate the opportunity permitted us to participate in the hearings by the subcommittee concerning the tax status of independent contractors and related issues. The American Movers Conference has approximately 1200 members representing all classifications and sizes of motor common carriers of household goods, with an underlying network of some 9,000 movers and 45,000 independent truck operators representing in total 200,000 people directly associated with the U. S. moving industry.

This statement has been formulated and prepared to provide background information along with our discussion of specific issues in light of the moving industry structure.

The Conference appreciates the opportunity to present this statement along with the American Trucking Associations, Inc., with which we are affiliated. As such, we endorse their statement. In that regard, our statement is intended to add to ATA's statement and discuss a specific sector of the trucking industry, and the importance of independent contractors to continued quality moving service for the American public.

MOVING INDUSTRY

The moving industry provides a unique door-to-door specialized service to the mobile American populace. The U.S. Census Bureau estimates 1 in 5 Americans change address each year, and approximately 1.3 million households are moved interstate annually by the interstate motor common carriers of household goods. Using the U.S. Census Bureau average of 3.3 people per family, the moving industry moves the personal possessions of 4.3 million people annually interstate. Additionally, millions of people are moved locally and intrastate by the moving industry.

In order to provide this personalized service where movers are entrusted with an individual's most personal possessions, a unique structure has developed which relies heavily on the small business concept. There are 2,794 household goods carriers certificated by the Interstate Commerce Commission of which nearly 99 percent are small businesses under Small Business regulations. Additionally, there are approximately 10,000 local community movers located throughout the United States, most of which are tied together by a contract with a van line of carrier possessing interstate authority. Nearly everyone of the 10,000 movers are small businesses. They are known as agents, and provide local services for the certificated carrier such as packing and unpacking. Additionally,

many of the local community movers have interstate authority for several states or even a region. As a result, community movers may have a certificate to move household goods under their authority or as an agent for another carrier. Finally, some carriers will interline with another carrier so that the independent truck operator will be transporting household goods moving under the certificate of two or more carriers.

Either the agent or the carrier may have a long-term or permanent contract with the independent truck operator and become part of the permanent fleet. On the other hand, the moving industry is seasonal with 60 percent of the people moving during the summer months. During this period, many more independent truck operators will enter into an intermittent contract with the agent or carrier, and in some cases the agent will enter into a contract with the carrier so the independent truck operator's contract is with the agent; but through the agent's contract with the carrier, the independent truck operator would be transporting household goods for the carrier.

In the moving industry, there are approximately 45,000 independent truck operators transporting household goods interstate during the peak summer season. The number during the non-peak season may decline to about 36,000. The vast majority of the independent truck

operators own their power unit and many own both the power unit, trailer and accessorial equipment.

Some own 2 or more units. In all cases, the independent truck operator is responsible for the expenses of the operation including fuel, tolls, fees, subcontractors, and maintenance. The contract will provide for a percentage distribution of the revenue from the shipment transported with independent truck operators generally receiving between 50 to 70 percent of the total revenues. This will vary depending upon the amount of services performed by the independent contractor, and in some cases is subject to negotiation telephonically at any stage prior to performance under the contract.

This is necessitated because of the irregular route nature of the industry where an independent truck operator may pick up and deliver shipments for an extended period of the time, and over the entire United States. Some areas of the country are less profitable to the independent truck operator under a normal contract which necessitates instantaneous negotiation similar to changing the contract for the construction of a building when additional services or conditions are required.

While performing the contract, the independent truck operator is subject to the terms and conditions thereof which may contain various governmental requirements.

Motor common carriers of household goods are one of the most highly regulated industries in the general economy. Those regulations are found at Title 49 of the Code of Federal Regulations, and include a penalty of up to $500 for each violation of more than 200 non-economic regulatory requirements on every shipment.

Often, when the independent truck operator arrives at an origin or destination location, he is required to contract with a subcontractor (casual contractor) to load or unload a shipment. This subcontractor generally demands X number of dollars, depending upon the size of the shipment and the conditions surrounding the loading or unloading, such as the number of stairs. This subcontractor is used generally on a one-time basis, and the contract is for a certain sum, regardless of the hours involved.

INDEPENDENT CONTRACTOR STATUS

From the discussion, supra, the Conference believes the value of independent truck operators to the moving industry to be well established. Additionally, the statement of the American Trucking Associations, Inc., details the trucking industry's position with respect to independent contractors under the common law and on various legislative proposals.

However, because the intent of any legislation would be to remove any uncertainty on the determination of independent contractor status, the Conference offers several observations in the event Senator Dole's bill (S. 736) were to be altered or the subcommittee should consider other legislation.

We support, as the statement of the American Trucking Associations, Inc., discloses, the Dole bill; however, "it is not without problems" which some minor modifications could address.

If the assumption were made that the "safe harbor" tests contained in the Dole bill do not cover independent truck operators, then there is an absolute necessity for inclusions of a "no inference" provision to definitionally return the status of independent truck operators to the common law. Under the common law, it has been consistently determined such operators are independent contractors. However, historically determined independent contractors under long established principles should either fit within the "safe harbor" provisions, or be grandfathered in so that certainty would prevail.

We recommend a provision be included which would provide the kind of certainty the general economy needs by grandfathering as independent contractors those individuals or entrepreneurs traditionally accorded contractor status.

Further, a closer examination of the safe harbor tests for moving industry independent truck operators may enlighten the subcommittee's consideration of these issues.

There is little question independent truck operators control the hours worked with at least two exceptions -- both mandated by governmental law and regulations. Household goods, consumers and the moving industry are required to agree upon specific pickup and delivery dates. As such, the industry may be subject to sanctions if such dates are not met. Thus, the independent truck operator may be required by contract to perform the service by or on a specified date. How the independent truck operator travels or the hours worked are within the operator's control so long as the specified dates are met. This provides a unique service to the nation's moving public. The hours worked are further subject to the U.S. Department of Transportation safety regulations which operationally limit the hours any operator (regardless of whether under a contract or totally independent) may work.

This definitional distinction could be remedied easily by excluding governmentally mandated controls which apply to industries regardless of whether the individual is an employee, and independent contractor or

a totally independent businessperson. Such governmental mandates with a congressional intent other than for tax purposes (such as safety or consumer satisfaction) should not be considered under the safe harbor tests. Any such controls are for the public interest and should not reflect adversely on the determination of whether or not an individual is an independent contractor. An additional clarification could be made by inserting the word "or" in lieu of "and" in the next to last line between "work" and "substantially". These two determinables are disjunctive rather than conjunctive, and are not considered the latter under the common law.

The independent truck operators' principal place of business would be their house or the "tractor" or power unti. Many literally take their office with them wherever they go.

Most independent truck operators have a substantial investment in assets used in connection with the performance of the service, depending upon the definition of "substantial" and the independent truck operator's contract in relation to the total contract for moving the household goods.

There is little question the independent truck operator risks income fluctuations. The operational

management of the business determines income fluctuations: e.g., where the fuel is purchased, economy of equipment, whether maintenance is self-performed or contracted out, and what routes of travel are used. Provided "output" in clause (B) includes operational considerations such as those above, then the independent truck operator would be included. On the other hand, if "sales" is meant to qualify "output" in such a way as to limit the application of this clause to revenue producing activities, rather than normal business considerations where profit levels are based on either revenue production or cost containments, then traditional independent businesspersons, including independent contractors, would be limited in such a way not contemplated by the common law nor common business practices. Additionally, the business concept "volume" may be distorted by the last expression removing "the number of hours" worked from the profit margin considerations.

Both safe harbor tests (4) and (5) are currently performed by the moving industry.

TREASURY PROPOSAL

The U. S. Department of the Treasury proposed, among other matters, "A flat rate of ten percent be withheld from payments made in the course of a payor's

trade or business for services provided for certain independent contractors."

We submit that such a proposal, if it were to become law, would be devastating to the financial health of the moving industry. The moving industry structure, as discussed above, requires financially healthy, independent truck operators. According to the Household Goods Carriers Bureau (authorized by the ICC to, among other matters, gather pricing information) in 1977, the last year for which statistics are available, the average annual gross revenue for a household goods independent truck operator was $52,264. Average annual gross expenses for the same year were $39,497, having a net of $12,767 or 24.4 percent of the gross revenue. If the gross revenue for 1977 were increased by an annually adjusted amount equivalent to the Interstate Commerce Commission's approved tariff increases since 1977, the resulting gross revenue would be $57,752. At the same time, if the annual expenses were increased by the increase in the consumer price index from 1977 through April of 1979, the annually adjusted average expenses would be $45,935 having a net of $11,817 or 20.5 percent of the average annual revenues.

Further, the Interstate Commerce Commission in various weekly updates in Ex Parte No. MC-311, EXPEDITED

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PROCEDURES FOR RECOVERY OF FUEL COSTS, has determined the cost of diesel fuel has increased at 7.5 percent of the rates in effect on January, 1979. By the Commission's regulations, the full 7.5 percent rate increase must be passed on to the independent truckers because of the equivalent cost increase. Thus, the average annual revenues adjusted for the increased cost of fuel would be $62,064 and expenses $50,262, leaving $11,817 or 19 percent.

The government has determined the additional fuel surcharge is equivalent to the cost of the fuel. Therefore the cost of the fuel should be equal to the revenue generated by the surcharge rate increase and result in no additional tax liability. Yet, under the Treasury Department's withholding proposal, the independent truck operator could be subjected to a 10 percent loss of gross receipts needed to purchase the fuel. The Interstate Commerce Commission, in a decision served June 26, 1979 in Ex Parte No. 311, EXPEDITED PROCEDURES FOR RECOVERY OF FUEL COSTS, stated: "The Commission emphasizes that this surcharge should ensure that all owner-operators should receive compensation for virtually 100 percent of fuel cost expenses...."

And in a Commission decision served June 15, 1979, in the same proceeding, regulated carriers were required to adjust their contracts so the exact amount of the

fuel surcharge increase determined by the Commission on a weekly basis would be automatically passed through to the independent truck operator.

If the moving industry were required to withhold 10 percent or any percent of the surcharge pass through, they would be in violation of Interstate Commerce Commission regulations and subject to fines and other penalties.

Additionally, the financial chaos independent truck operators would be subjected to under a withholding scheme is apparent.

To pass the burden of determinating when tax liability is equal to or by some regulation at an X percent level of the amount that would be withheld if a withholding requirment existed is unconscionable. The payee, in this case the independent truck operator who hauled one shipment at the beginning of the period and expected to be under the contract for the full period, but experienced mechanical problems or the loss of the equipment by accident, could be considered in violation of an "option" provision. As discussed, supra, there are an infinite variety of variables affecting independent truck operators. It would be impossible for them to accurately determine on a 100 percent basis whether or not they qualified under an option for exclusion to the withholding requirement.

Additionally, the administrative nightmare that would be thrust upon the payor would require substantially

additional personnel to meet any requirement under a withholding provision. There are continual adjustments in the contracts. Loans are made by payors to payees for a myriad of reasons over the course of the contract. If the independent truck operator enters into a contract lease with the regulated carrier, the relationship reverses, and the independent truck operator would becomes the payor and the regulated carrier the payee. Should the independent truck operator then be required to withhold monies from the regulated carrier payee? Thus, the complicated business relationship between contractors and contractees in the moving industry takes on added significance.

The relationship between independent truck operators, the moving industry and casual contractors needs to be examined very closely in light of a withholding scheme. As discussed above, many independent truck operators contract with casual contractors for loading and unloading services. Generally, the contract may average $35 to $40 for the one-time service. If the independent truck operator were subjected to the administrative burden of withholding $3.50 to $4.00 for each casual contractor, a substantial paperwork, financial and banking requirement would be added to an already burdened businessperson. The casual contractor generally would

be subject to the negative income tax provisions of the Internal Revenue Code, which would not enhance the Treasury. Also, generally the casual contractor contracts for a specific amount and would not accept less, thus requiring already financially burdened independent truck operators to pay the withholding tax from their already severely restricted profit margin. And, for the independent truck operator to maintain records on the monies that would be withheld, and properly deposit them at a bank in accordance with Internal Revenue Service regulations would be adminstratively impossible. The independent truck operator may be on the road for 30 to 60 days before returning to their base. In the event the operator was on the road at the time it would be required to bank such monies or adminstratively perform the various paperwork requirements, the result would be the independent truck operator having banking transactions throughout the country. In conclusion, such a scheme would result in a windfall to the government at the expense of an already administratively overburdened segment of the private sector.

Returning to withholding on independent truck operators-- assume an independent truck operator opted to have withholding, and for 7 months a percentage was withheld. Then the independent truck operator's equipment

malfunctioned, requiring an expensive replacement of an engine. It is conceivable the independent truck operator may not have the financial backing to replace the engine, which would result in the loss of the equipment and termination of the contract. On the other hand, if the withheld money were available, the operator could replace the engine. One carrier's experience indicates 70 percent of the independent truck operators terminate their contract within the first year, and 10 percent continue their contract for a period in excess of three years. Studies have indicated the primary reason for the turnover is the independent truck operator's business acumen. With a withholding provision, far more independent truck operators would be unable to survive. It is the first years that are vital to the survivability of the operator.

Additionally, during the first years, generally, there is little or no tax liability because of the investment tax credit.

Assistant Professor of Business Adminstration, Mr. David H. Maister, at Harvard Business School in a speech, noted in the July 23, 1979 issue of TRAFFIC WORLD, stated: "What all this means is that the motor carrier industry is going to have to put a lot of effort into matching up an increasing demand (for owner-operators) with a

static or declining supply." He went on to state: "And that means recruiting new entrants into the industry... I see only one, the van lines, (moving industry) that are going all-out in this direction."

CONCLUSION

Thus, any withholding provision at this time without further study would be devastating to the moving industry at all levels. In order to assure certainty and a financially healthy industry, the American Movers Conference strongly encourages the subcommittee to address the definitional question initially, and provide for further more specific studies by the Treasury Department with respect to a withholding scheme. Such studies should consider the many facets of a particular independent contractor as discussed above so the subcommittee can knowledgeably consider legislation in the future to address any problems which may exist between independent contractors and the U. S. Government.

Once such studies were completed, profiles could be used to zero in on the specifics a withholding scheme should contain to address the more limited problems the study would disclose. A shotgun approach as recommended by the Treasury Department considers neither the uniqueness of independent contractors nor the realities of the private sector of the economy.

Thank you.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
RE S. 736, THE EMPLOYMENT TAX ACT OF 1979

September 17, 1979

The American Farm Bureau Federation appreciates this opportunity to comment on S. 736, the Employment Tax Act of 1979.

Farm Bureau, representing over 3 million member families, has been in existence for over 60 years and is the nation's largest general farm organization.

One of the purposes of Farm Bureau is to provide a mechanism through which our members can analyze their problems and formulate any necessary action to achieve appropriate solutions. To provide for the insurance needs of farmers and ranchers, Farm Bureau-affiliated insurance companies have been established by many of the State Farm Bureaus. For this and other reasons we have a vital interest in the rulings of the Internal Revenue Service which affect independent contractors.

We are aware of the recent events which brought this issue before Congress, and we commend the Subcommittee on its diligent efforts to reach a fair and reasonable solution. A change in the classification of individuals who are now classified as independent contractors could have serious consequences on the operations of Farm Bureau-affiliated companies and thus work to the detriment of the interests of farmers and ranchers. Further, changes in classification could be detrimental to some individuals who perform work on farms and ranches and who are presently classified as independent contractors. In light of this, the delegates of the member State Farm Bureaus to the 1979 annual meeting of the American Farm Bureau Federation approved the following policy:

> "We recommend that the present independent contractor status of the affected individuals be preserved."

The American Farm Bureau Federation Board of Directors recently voted to support legislation containing the criteria specified in S. 736. This legislation will accomplish the overriding objective of preserving the status of workers who have historically been treated as independent contractors. We also feel that it is fair and reasonable as it permits the use of common law tests to classify those individuals who fail to meet all of the specified criteria. We urge the enactment of S. 736.

We thank you for this opportunity to present Farm Bureau's views.

ICESA

INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC.

September 27, 1979

The Honorable Harry Byrd
Chairman
Subcommittee on Taxation and Debt
Management
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Interstate Conference of Employment Security Agencies is very concerned about the potential impact of S.736 on the unemployment insurance programs administered by the State agencies we represent. Our membership includes the State Employment Security Agencies in the fifty States, the District of Columbia, the Virgin Islands and Puerto Rico. We are committed to the continuing improvement of the unemployment insurance system and indeed, the many programs which are administered by the State Employment Security Agencies. Should S.736 be enacted as currently framed, we believe that there will be significant repercussions in the administration of the unemployment insurance program. We would like to share our concerns with you and the members of the subcommittee.

As you know, S.736 was drafted to define new standards for determining whether individuals are employees or independent contractors. This bill has come about due to Section 530 of P.L. 95-600 which declared a moratorium on further modifications of the definition of employee until January 1, 1980. We fully support the effort to achieve the clarification called for in P.L. 95-600. However, the new standards provided in S.736 as currently drafted, differ significantly from the common law definition of employee used in many benefit and protection programs. We believe that many employees will inadvertently lose their rights to both benefits and other protections they are guaranteed by the Fair Labor Relations Act and the State unemployment insurance laws.

The need to determine whether a particular worker is an employee or an independent contractor is not a new issue, nor is it unique to Federal tax law. Indeed, most of the protection and benefit programs afforded to employees in the United States depend on the definition of an employment relationship between the worker and the employer.

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Workers compensation insurance, unemployment compensation insurance, rights to bargain collectively, many retirement and disability programs are among the types of programs which require an established employer-employee relationship. Traditionally, the determination of whether the worker is an employee or an independent contractor has been based on the well established principles of the common law. The status of the worker under all these programs is examined on a case-by-case basis and the key factor considered is the right of the principle to direct and control the manner and means in which the service is performed. The courts have applied these principles of direction and control broadly in a significant number of decisions, ensuring that workers in a true employment relationship are guaranteed all their rights to benefit ana protection programs.

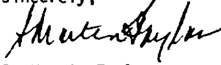
The States have found the axioms in the common law provide sufficient guidelines for determining the actual relationship between the principle and the worker, while being flexible enough to provide equity for both parties. We feel the provisions of S.736 may be too rigid to provide such equity. Under the proposed standards, workers who can normally control their hours of work, do not perform their work in a specified place of business provided by the principle, who have income influctuations and who sign a contract specifying the relationship is a contractor-principle relationship, would be considered independent contractors. Many workers could be placed in a tenuous position under these standards. For example, the written contract between worker and principle could well become a standard part of the application for employment in many situations. In fact, there are a number of court cases which have established that such written contracts do not form a sound basis for determining whether a worker is an employee or an independent contractor. Furthermore, the suggested provisions would effectively define persons paid-by-job, paid-by-piece, many drivers paid by the load or mile and a large number of casual laborers paid by commission or by the job as independent contractors.

In order to avoid the possibility of excluding many currently protected workers from the rights they are now guaranteed, we urge that the Congress consider the continued use of the principles of common law for determining the employment relationship on a case-by-case basis. If it is Congress' intention in S.736 to exclude specific groups of workers from coverage or that these groups of workers be affected in a particular manner, may we suggest for your consideration two alternatives. Each would achieve the objective of treating clearly identified groups of workers in specific ways, while retaining the common law definition of employee. The first alternative would be to enact narrowly drafted exclusions from FUTA coverage of specific types of workers, meeting specific characteristics. Several States have successfully enacted this type of legislation to exclude groups such as insurance agents and real estate salespersons, paid solely by way of commission, from coverage under their unemployment insurance programs. The second alternative for your consideration is amending Section 3508 (a) of S.736 to the extent that the proposed standards would not apply to individuals in a work environment which is considered an employment relationship under either the National Labor Relations Act or the unemployment insurance laws of the State in which the service is performed.

The Interstate Conference of Employment Security Agencies urges the Subcommittee to consider each of these alternatives in reporting S.736. Each would allow the continuation of the uniform and equitable basis currently used to determine the relationship between principle and worker, would maintain the integrity of the common law, would not disrupt the definition of employee used by employers when reporting to both the State and Federal taxing authorities and would ensure that worker's rights are preserved.

We thank you for the opportunity to present our views on the provisions of S.736.

Sincerely,



S. Martin Taylor
President

TAXATION OF FRINGE BENEFITS

STATEMENT OF THE

AIR TRANSPORT ASSOCIATION

OF AMERICA

The Air Transport Association of America represents virtually all of the scheduled airlines in the U.S. and therefore has a deep interest in the current hearings on the issue of employee fringe benefits before the Senate Finance Committee, Subcommittee on Taxation and Debt Management.

Airlines have provided free and reduced-rate travel passes to their employees since the very beginning of commercial air service. Such transportation passes are, and always have been, exempt from income tax under an IRS ruling originally issued in 1921. In recent years several regulatory initiatives to change the tax treatment of fringe benefits, including airline passes, developed. The airlines have opposed those initiatives pertaining to transportation passes not only because they would have improperly reversed long standing practice, but more importantly, they directly involved basic tax policy issues within the purview of the Congress.

Senate bill (S.224) would permanently prohibit the Internal Revenue Service from issuing regulations on the taxation of fringe benefits and, while this would resolve the problem of the taxation of air transportation passes, the Air Transport Association believes that the Congress should have the opportunity to study the matter in greater detail before passing a permanent prohibition.

The airlines believe the time has come to resolve the growing uncertainty caused by a variety of regulatory initiatives and encourage the Congress to establish practical and reasonable policy guidelines applicable to fringe benefits for the guidance of the U.S. Treasury Department and the IRS in issuing future regulations.

The airlines believe that such policy guidelines should permit employers to share facilities, goods or services with their employees arising from their businesses which incur no additional cost to the employer and which are available to all employees on a non-discriminatory basis, without increasing the employees' tax burden. The airlines are strongly opposed to any change in the long standing tax policy applicable to airline passes.

The proposed guidelines would provide an equitable solution to the problem of many employers, including the airlines, which have been permitted by judicial and administrative authorities to provide specific non-compensatory benefits to their employees in many cases throughout their history. If the Congress were to consider enacting legislative policy guidelines for the taxation of fringe benefits, the first step in the development of those guidelines would be to identify those facilities, goods and services, the receipt of which is properly excludable from gross income. Most authorities agree that certain benefits

may be excluded; however, the disagreement arises as to the appropriate guideline that should be applied in making this determination.

The airlines propose that the legislation should provide that where the employer provided his employees with facilities, goods and services that exist incidentally to his trade or business, the resulting benefit to employees or their immediate family should not be included in gross income if: a) the facilities, goods, or services are owned by or are under the control of the employer for purposes proper to the business involved and are primarily unrelated to the personal use of such items by employees of the employer; b) the facilities, goods or services are made available to the employees without the employer incurring substantial cost; and c) the facilities, goods or services are made available on a non-discriminatory basis subject to reasonable classification based on such factors as nature of work or seniority but not based on income.

Additionally, the provision of facilities, goods or services should not be considered compensation includable in gross income when the amount of the item is so small or so difficult to value that accounting for it would be unreasonable or administratively impractical.

This proposal is similar to guidelines previously proposed by the Department of Treasury, but which were not adopted because clear legislative authority was lacking. The

airlines recommend that distinct legislative jurisdiction be established which would result in a fair and equitable policy in this extremely difficult and sensitive area. It would provide guidelines to both industry and government without major revenue impact and would remove the cloud of uncertainty that exists.

While the airline proposal would result in taxation of heretofore untaxed employee benefits, air transportation passes would continue to be excluded from gross income as they have for more than four decades. This exclusion is compelled by several very simple facts:

- An airline's schedules and its frequency of operation are determined by economic consideration with no regard for the desires of pass passengers.
- Since pass passengers generally travel on a space available basis, their transportation results in no added expense to the airlines. Indeed, payment of any required service charge by the pass passenger reimburses the carrier fully for use of an otherwise commercially wasted vacant seat.
- The passes are offered on a non-discriminatory basis.
- Airline employees can neither give, sell nor otherwise transfer their tickets to any other person nor surrender them for cash or for any item of value; nor can an employee use a pass issued by one airline on another airline.

Moreover, efforts to place a value on passes would create an administrative and accounting nightmare due to the myriad of discount, stand-by, and other conditional airline fares against which a pass might be compared and in view of the significant rules and restrictions placed upon airline pass travelers.

An additional point should be made on a matter which has been viewed with concern by certain employee fringe benefits analysts. The fear is that employers will use or have used tax free fringe benefits as a substitute for cash compensation or as a tactic for increasing compensation to employees in a tax free manner. Whether this concern applies broadly to all classes of fringe benefits is unclear. What is clear is that airline employees are compensated with high wages. Government studies over the years have shown again and again that airline employees are among the very highest, if the not highest paid workers in the United States. As repeated findings of federal agencies in courts have demonstrated, transportation passes are not a form of airline employee compensation.

It is obvious that the passage by the Congress of S. 224 would alleviate forever the uncertainty regarding IRS regulations on fringe benefits. The airlines do not believe it would completely remove the uncertainly regarding judicial actions which may be taken. If the Congress fails to enact the moratorium, the Treasury will then be free to issue regulations without any guidelines from the Congress on the issue of fringe benefits as taxable income. The airlines believe that the Department of Treasury needs policy guidelines in order to adequately prepare the regulations which would be necessary to implement, and to clarify the tax status of the myriad of fringe benefits that exist. The airlines believe that the use by an employee of an employer's ongoing service when that

use presents no cost increase to the employer and is available on a non-discriminatory basis should not result in a finding of taxable income to the employee.

The basic test to be met in condsidering the tax treatment of an employee's fringe benefits is whether or not they really represent compensation. Airline transportation passes clearly do not. It would be unfortunate if in the consideration of Congressional policy, the conclusion was reached that all fringe benefits should be treated identically regardless of the differing purposes, applications, origins and merits. A rule of reason and practicality is required which should be the purpose of the policy guidelines issued by the Congress for the guidance of the U.S. Treasury Department and the taxpayers of the United States.

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STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE TO THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT RELATING TO THE CLARIFICATION OF THE EMPLOYMENT TAX STATUS OF INDIVIDUALS
OCTOBER 11, 1979

The purpose of this statement is to present the views of the American Council of Life Insurance on the issue of classifying workers, particularly life insurance salesmen, as either employees or independent contractors for employment tax purposes. The American Council of Life Insurance is the major trade association of the life insurance business with a membership of 491 life insurance companies which, in the aggregate, have approximately 95% of the life insurance in force in the United States and hold 97% of the assets of all United States life insurance companies.

SUMMARY

We generally support S. 736, a bill introduced by Senator Dole which would amend the Internal Revenue Code to provide certain tests for determining the status of individuals for employment tax purposes. If an individual satisfies all of the requirements set forth in the bill with respect to services performed by him, he will be treated as an independent contractor for employment tax purposes. We believe that enactment of S. 736 will provide the certainty and uniformity that is essential to the effective operation of the employment tax laws. We also believe that since S. 736 provides only a "safe harbor" test for determining employment tax status, a provision should be added to make it clear that if any of the "safe harbor" standards are not met, determination of employment status will be made under the common law rules, as if the "safe harbor" criteria had not been enacted.

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The Administration proposes to resolve the question of classifying an individual as either an employee or independent contractor basically by requiring that a flat 10 percent be withheld from payments made in the course of a trade or business for services provided by independent contractors. The existing imprecise tests would be retained for determining whether the persons performing the services are independent contractors.

Enactment of such a proposal would not, in our view, solve the classification problem since even with withholding, the classification of a worker would be important if for no other reason than to determine which withholding system to use, i.e., the Administration's flat withholding percentage or the graduated withholding system for employees. Moreover, we believe there are serious administrative problems with the Administration's proposal so as to make it unwise to adopt at this time. Finally, if the decision is made to adopt the Administration's proposal, we urge that, since most life insurance salesmen are either already subject to Social Security tax withholding or would qualify for an exemption from the proposed 10 percent withholding, commissions paid to life insurance salesmen not be subject to withholding.

Background

Currently, Code §3121(d)(2), with certain specific exceptions, 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." Basically, the common law is a set of factors based on court decisions and custom which is used to classify an individual as an employee or independent contractor.

The focus of the common law in this area revolves around the employer's right to control the way an employee works, both as to the final result and as to when and how that result is accomplished. (The IRS has adopted twenty factors to be considered in determining employment status.) In making this determination, no single factor is conclusive. Moreover, the degree of importance of each factor varies in each case.

Application of the common law rules to complex and changing business arrangements is very difficult and has produced inconsistent results. At best, a decision to go one way or the other as respects a particular relationship involves a significant degree of uncertainty as to how the IRS will react. These problems are particularly pertinent when attempting to classify a life insurance agent because of the myriad of arrangements between agents and their companies that are used to market life insurance.

Despite the inherent weaknesses with the common law standard for determining whether an individual is an employee or independent contractor, the impression was created for many years that the common law definition of "employee" was a workable standard, since the IRS, until recently, raised few challenges regarding the employment tax status of individuals, including life insurance agents. During the past few years, however, the IRS has increasingly challenged the previously unquestioned employment tax status of workers in many industries and occupations, including the life insurance business. The experience of our member companies indicates that these employment tax audits appear to involve a change of position by the IRS and, in some cases, a rejection by the IRS of prior private letter

rulings issued to companies holding agents to be independent contractors. This increased audit activity and challenges have substantially eliminated the predictability that at one time seemed to exist and have made it clear that the common law definition is clearly too imprecise to be the primary test used in determining the employment tax status of individuals.

The Administration's Proposal Does Not Address the Problem of Classifying Individuals

The Administration's proposal for resolving the independent contractor/employee definitional problem is essentially to duck it. Instead, its solution is to require that a flat 10 percent be withheld from payments made in the course of a trade or business for services provided by an independent contractor. The Administration assumes that with withholding, the number of disputes involving employment tax status will be reduced, the pressure on the common law definition will be relieved and the definitional problem will, thus, largely disappear.

We strongly disagree with the Administration's assumptions. We believe that even if the Administration's withholding proposal was adopted, classification of individuals would still be important, and the pressure on the common law definition would remain.

First, it would be necessary for an employer to decide which withholding system to use, i.e., the 10 percent flat rate or the graduated withholding system normally applicable to employees. The fact that the Treasury proposes a different withholding system for independent contractors, i.e., a flat rate and an election for individuals who would be overwithheld to elect out of the system, indicates that even Treasury believes that a graduated withholding

system is not appropriate for payments made to independent contractors. Therefore, it would still be important for businesses to properly classify individuals. In this regard, we find it hard to believe that the IRS will cease to question an employer's classification of an individual as an independent contractor merely because 10 percent may have been withheld from the payments to him. Moreover, to the extent either of the two exceptions to withholding allowed under the Treasury proposal are available, there would be no withholding and no reason for the IRS not to continue raising challenges regarding the employment tax status of those individuals.

Proper classification of workers would also be important in connection with the Administration's proposed penalty tax. The Treasury proposes that a 10 percent penalty tax be imposed on an employer with respect to past payments to workers who are classified as employees, in lieu of that employer's current withholding tax liability. If the employer's classification of a worker as an independent contractor was reasonable, however, and he also satisfied the proposed withholding rules, the penalty tax would be abated.

Without clear and objective standards for determining employment tax status, the common law rules would have to be used to determine whether the employer's classification was reasonable. There is no reason to believe that the IRS' application of the common law rules in this area would be any more consistent or predictable than it has been recently in its employment tax audits. Moreover, while the "reasonable" exception may protect an employer as regards past determinations, he still will have to decide how to classify workers for the future.

Finally, classification as independent contractors is important from many life insurance agents' point of view. These agents view themselves as professional independent businessmen. The recent IRS audit activity, reclassifying many of them as employees, has had a very disturbing impact upon them.

In summary, therefore, we believe that unless Congress enacts substantive legislation setting forth appropriate and clear tests to be used in classifying individuals as employees or independent contractors, all the uncertainties and controversies involved in recent employment tax audits will reappear as soon as the interim relief enacted by Congress in the Revenue Act of 1978 expires.*/ This will be true whether or not the Administration's proposed withholding system is enacted.

S. 736 is an Appropriate Solution

S. 736, a bill introduced by Senator Dole, is designed to provide a permanent solution to the problem of classifying workers for employment tax purposes. S. 736 sets forth five requirements which, if satisfied, would result in a worker being treated as an independent contractor.

To fall within S. 736's safe harbor, an individual: (1) Must control the number and scheduling of hours worked; (2) Must not have a principal place of business or, if he has one, it cannot be provided by the person for whom the service is performed unless reasonable rent is paid therefor; (3) Either must have a substantial

*/Section 530 of the Revenue Act of 1978 prohibits the IRS from adopting any regulations or publishing any rulings with respect to the employment tax status of any individual, before January 1, 1980. In addition, the IRS is prohibited from reclassifying an individual as an employee for any period ending before January 1, 1980, if the business firm has a reasonable basis for treating such individual as an independent contractor.

investment in the assets used in connection with the services performed or must risk significant income fluctuation; and (4) Must perform the services pursuant to a written contract that spells out his status as an independent contractor and the tax obligations associated with that status. Moreover, the person for whom such service is performed must file all information returns required with respect to such service.

We believe S. 736 represents the best approach yet formulated for clarifying the employment tax status of individuals, including life insurance agents.*/ The requirements set forth in S. 736 are, in our view, an appropriate dividing line. The tests can be easily applied and will provide the certainty and uniformity that is so necessary if our tax laws are to work efficiently and effectively. As previously indicated, the Administration's alternative of doing nothing as regards the classification question does not resolve the problem at hand.

Although S. 736 will provide most individuals, including most life insurance agents, with certainty regarding their employment tax status, because of the myriad of arrangements between individuals and the persons for whom they perform their services, there may be situations where a clear determination of employment tax status may not be able to be made under the requirements set forth in S. 736. Therefore, we believe there is also a need to continue the use of the common law tests in determining employment

*/In this regard, we wish to point out that a substantially identical bill, H.R. 3245, has been introduced in the House by Representative Gephardt. The Council testified in support of H.R. 3245 at hearings held by the Select Revenue Measures Subcommittee of the House Ways and Means Committee on July 16, 1979.

tax status, where an individual fails to satisfy one or more of the basic criteria contained in S. 736. Accordingly, we recommend that a "no inference" provision be added to S. 736 which would provide that, in cases where one or more of the "safe harbor" requirements are not met, a determination of employment tax status shall be made under the common law rules, as if the "safe harbor" provisions of S. 736 had not been enacted.

The Administration argues that S. 736 would permit workers, including life insurance agents, to be treated as independent contractors. This implies, of course, that without S. 736, life insurance agents would be treated as employees. It ignores the very real controversy that has developed over recent years and which lead to the stop gap legislation passed last year and the efforts by Senator Dole and others to come up with a rational and administrable set of guidelines.

The Administration also cites the possibility of "manipulating" an employer-employee relationship to meet the requirements of S. 736 as a reason for opposing the bill. There is a strong implication that such "manipulation" would be for tax-avoidance purposes. For whatever reason, if an employer and an employee rearrange their working relationship so as to meet the independent contractor criteria, that change should be recognized--it is more than mere manipulation. The real issue is whether the criteria are correct.

The Administration's Withholding Proposal is Unnecessary for Life Insurance Agents

As regards the Administration's withholding proposal, it should, as we previously indicated, be treated separately from the

question of develop[illegible] criteria for classifying individuals as employees or independent contractors. The proposal obviously results from the alleged high rate of noncompliance by independent contractors with regard to the payment of Social Security tax (SECA) and income tax. We are pleased to note, however, that the Administration's statistics indicate an extremely high degree of compliance by the life insurance business. Thus, only 1.7 percent of all the compensation received by life insurance agents is not being reported. Thus, as a general matter, we do not believe it is necessary to subject life insurance companies and their agents to the complexities, burdens and costs that would be involved in implementing the Administration's withholding proposal.

But even beyond this, we believe that insurance commissions should be excluded from any new withholding system because the bulk of them are either presently withheld upon or would qualify for an exclusion under the proposal. In this regard, full-time life insurance salesmen who are self-employed independent contractors are presently characterized as employees for Social Security purposes. (Section 3121(d)(3)(B) of the Code.) Contributions to the Social Security system for and by these salesmen are made under the Federal Insurance Contributions Act (FICA). Thus, a combined contribution at a rate of 12.26 percent (both the employer and the salesman currently contribute 6.13 percent under FICA, with the salesman's contributions being withheld from his commissions) is already made, and it exceeds the 10 percent flat withholding percentage recommended by the Administration, which would first be applied against the Social Security tax liability. Also, the total

compensation paid to a full-time life insurance salesman must be reported on Form W-2, which is attached to the income tax return. Thus, as indicated from the compliance figures, the system of reporting, matching and enforcement as regards these taxpayers works very well.

Another group of life insurance agents are classified as employees by their companies and, thus, are not subject to the regular withholding procedures.

The other large group of life insurance salesmen are independent brokers. As the name implies, a broker usually has no allegiance to any one life insurance company and places insurance with a number of life companies. Therefore, this group of salesmen would be able to elect out of the Administration's withholding system under the five or more payor exception.

Thus, it would provide little advantage to require insurance companies to gear up for a new withholding system for commissions. From the company's standpoint, implementing the withholding system would necessitate the processing of many, many exemption certificates to cover commissions paid to brokers. The cost-benefit ratio of the system would, therefore, argue against it.

The Administration's Proposal Raises Many Broad Based Problems

Aside from the particular situation for insurance commissions, the Administration's proposal, in its present form, presents severe problems. The fault with the proposal is that it is much more pervasive than it appears on its face and, if adopted, will require payors, in even the most casual transactions, to either be the collecting agent for the Government, often resulting in overwithholding,

or to process massive amounts of paper to establish that withholding is not required. We question whether it is appropriate to place these burdens on payors and payees.

More specifically, we believe the withholding proposal will result in an administrative nightmare. A life insurance company hires many independent contractors to perform specific functions that are necessary to the operation of its business. For example, a company may hire doctors to perform physical exams on potential policyholders, consultants to give advice on specific subjects or service people (painters, plumbers, electricians) to handle problems with the building which houses its offices. Under the Administration's proposal, unless such an individual who performs a service files the required form electing out of the system, the life insurance company must withhold 10 percent from the payment to that individual.

As a practical matter, individuals in many cases either will fail to file the required form because of inadvertence or forgetfulness or will not file the form in time for a payor to process it before making payment. In addition, payors will have to develop a system to receive and process the massive amounts of forms electing out of the system that will be filed with them. The confusion and misunderstanding this withholding proposal will generate is unimaginable.

We recognize that there may be a noncompliance problem regarding payments to independent contractors. However, we believe the Administration's solution to the problem is too comprehensive, unnecessarily burdensome and complex and expensive. Therefore, we

recommend that the Administration's proposal to withhold a flat percentage from payments to independent contractors not be enacted. However, if the decision should be made to adopt a change in this area, we recommend that any withholding be limited only to those groups where a serious noncompliance problem has been demonstrated.

Strengthening Information Reporting Requirements

We agree with the Administration's recommendations for strengthening the information reporting system. We believe payees should be given a copy of any information return filed with the IRS so that there is no doubt about the amount of compensation to be reported by them. Moreover, to assist the IRS in its enforcement function, we suggest that the information return be required to be attached to the individual's tax return, as is currently the case with Form W-2.

Finally, we do not object to the proposal to increase the penalties for failure to file an information return with the IRS and to apply this penalty to the failure to furnish such return to the payee.

Conclusion

In conclusion, we reiterate our support for S. 736 and urge that the Subcommittee favorably report the bill to the full Finance Committee as quickly as possible. Further, we recommend that the Administration's withholding proposal not be adopted. However, if the decision should be made to adopt the proposal, we strongly recommend that commissions paid to life insurance agents be excluded.

We appreciate having the opportunity to present the Council's views on the issues of classifying workers for employment tax purposes. We would be happy to attempt to answer any questions the Subcommittee may have.

Respectfully submitted,

AMERICAN COUNCIL OF LIFE INSURANCE

Stephen W. Kraus
Assistant General Counsel

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Chief Counsel
Federal Taxes and Pensions

STATEMENT OF MITCHELL S. FROMSTEIN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF MANPOWER, INC., IN CONNECTION WITH THE PUBLIC HEARINGS ON S. 736, RELATIVE TO THE TAX STATUS OF INDEPENDENT CONTRACTORS, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

October 12, 1979

My name is Mitchell S. Fromstein and I am the President and Chief Executive Officer of Manpower, Inc., a worldwide service firm supplying temporary help to business firms in over thirty countries.

I am submitting this statement in connection with S.736 to inform you of the gross inequities that many franchisors and franchisees would face if a proposed IRS position, which the IRS actually attempted to apply to Manpower and its franchisees, were expressly or implicitly approved by Congressional action now being considered by your Committee. I believe that this proposed IRS position would bring about dislocations in normal business relationships which the Congress would not knowingly impose on franchisors, independent franchisees, the employees of the franchised businesses, and, ultimately, the customers of those independent businesses.

The structure of Manpower in the United States is typical of many franchise businesses. Manpower has approximately 300 license agreements under which independent businessmen are licensed by us to carry on a business within a defined geographic territory. In addition to this large group of franchisees or licensees, the company owns and operates approximately 100 units of its own. Manpower franchises alone are responsible for the employment of over 200,000 temporary workers each year.

Licensees or franchisees who participate in this kind of relationship are independent entrepreneurs in every sense of the word. They invest their own money in equipment and

facilities; they are totally at risk as to profits and losses from operations; they complete their own customer billings and collections and retain all funds received as revenues. In every instance, they are required, under our license agreement, to establish a corporation through which all of their business is conducted, and with very rare exceptions they are active employees of that corporation. Our only relationship with these people consists of two elements: First, there is a franchise or license fee which is paid to our company based upon gross sales in the franchised area. The fee is a minor part of the total revenues and averages less than 5%. The other element is one in which our company, in return for license fees, provides various national advertising, operational systems and technology, along with the right to use our brand name, Manpower, Inc., on a continuing basis. We have maintained this relationship with our licensees for a period of over 25 years. These franchises have been bought and sold frequently. Most of them have accumulated corporate net worth of hundreds of thousands of dollars, some in excess of one million dollars.

In 1976, an IRS agent claimed that these independent businessmen-licensees were actually employees under the common law doctrine of employee/employer relationships and asked of us the payment of additional taxes estimated at between $14,000,000 and $16,000,000. This assertion of taxes was based on the view that all of the net income of all the corporations licensed by us throughout the country was in fact compensation paid by

Manpower to our franchisees on which we, Manpower, Inc., should have been withholding income taxes and paying Social Security taxes. Our lawyers, and indeed some IRS officials who examined the matter, could find no direct support for the suggested IRS position, but we were nevertheless required to spend three years and a quarter of a million dollars to fight the claim. It was not, in fact, until the Congress, in its wisdom, suspended all IRS proceedings in regard to independent contractors as a part of the Revenue Act of 1978 that we were at least temporarily relieved of these enormous additional tax liabilities.

If that claim or any other based upon the same principles had prevailed, it would have signalled the end of franchising programs such as ours, and precipitated a host of legal problems between franchisors and franchisees. How would franchisors collect the money on which withholding could be made? They necessarily would have to obtain funds from the franchisees sufficient to meet the withholding obligation. In turn, the franchisees would have to deposit with their franchisors a portion of their gross revenues sufficient to meet this separate and duplicative withholding obligation, whether or not such revenues were derived entirely from the performance of services. The result would place upon the franchisees an overwhelming financial burden. The consequences would ultimately require abandonment of the useful and efficient independence of the franchisees from franchisors.

The Congress is now considering whether employee/employer relationships should continue to be determined only by the common law elements of "supervision and control." A new set of tests of the affected relationships may be enacted. As a result of our frustrating experiences of the past three years and our full and deep knowledge of what employee relationships indeed are, we applaud the effort to introduce order, predictability, and fairness into these determinations. On the general questions of concern, our views are consistent with those that have been expressed by the International Franchise Association, of which Manpower is a member.

We strongly support the intent of S.736 to establish a "safe harbor" which would clarify that certain relationships are not that of employer-employee. Our recent dislocating experience with the IRS would be prevented from recurring if there were a clear statutory statement that for purposes of this legislation franchisees are neither employees nor independent performers of personal services for franchisors.

By all rules of logic, the safe harbor should not be needed. If the franchisee does not perform services for the franchisor, and if the franchisor makes no payments to the franchisee, both of which are facts in the overwhelming majority of franchisor relationships, the question of withholding should not even arise. Despite this, as I have already described above, the question has not only arisen, but has threatened the survival of hundreds of our franchisees as independent businessmen. For this reason we strongly urge clarification of the language in

S.736 to establish that franchisees shall not in any event be considered to be individuals providing personal services to franchisors.

The problem that I have described would be exacerbated by enactment of HR 5460, the Independent Contractors Tax Act, introduced in the House by Chairman Ullman and others on September 28, 1979. By introducing and defining the phrase "service recipients," HR 5460 fails in terms to establish that franchisors are not "service recipients" in their relationships with franchisees. Further, the bill includes a requirement that a 10% tax be withheld on all payments to independent contractors. There is reason to expect that if HR 5460 or any similar bill were enacted, the IRS would return to us with the claim that our franchisees are subject to withholding tax either as employees (because they failed to qualify for inclusion in the safe harbor, and the IRS resumed its tortuous application of common law) or as independent contractors because they succeeded in qualifying for inclusion in the safe harbor, (thereby becoming subject to the 10% withholding under HR 5460). We would make the same explanation to them as we did before, pointing out that we receive no revenues on which we can withhold monies and that our licensees are, in fact, independent businessmen with respect to whom income tax and employment taxes are already being paid. That is, they are employees of the corporation which is already withholding taxes on their salaries and <u>they are neither employees nor independent</u>

contractors performing services for the franchisor. Sadly, I must anticipate that we would receive the same rejection of our position and be handed another assessment amounting to more than our annual corporate earnings.

Accordingly, I am urging Congress, on behalf of ourselves and literally thousands of companies and their licensees throughout the nation, to include in any redefinition of employee status, and in any imposition of tax withholding on payments to independent contractors, a provision that will effectively prohibit the IRS from asserting a withholding or employment tax liability with respect to relationships that cannot fairly be viewed as involving the performance of personal services by one party for another. This could be done in a brief and uncomplicated manner by providing that amounts earned by a franchisee in the course of his business are not to be treated as amounts received from the franchisor and that a franchisee is not to be treated as a person performing services for the franchisor within the meaning of this legislation.

The desired exclusion would protect thousands from the arbitrary and capricious, and often even whimsical, searches of the IRS for unnatural ways to enforce tax collection when a very natural one already exists. At the same time, it would assure small businessmen everywhere that the Congress of the United States understands the problems of business and will intervene to prohibit a baseless and unintended application of its laws by government bureaus and agencies.

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Statement of the

EDISON ELECTRIC INSTITUTE

TAXATION OF FRINGE BENEFITS

This statement is submitted on behalf of the Edison Electric Institute (EEI), which is the principal national association of investor-owned electric utility companies. Its member companies serve approximately 65,600,000 electricity consumers--77 percent of the Nation's electricity users and 99 percent of all customers of the investor-owned segment of the electric utility industry.

EEI urges the enactment of S. 224, a Bill which wisely would permanently prohibit the issuance of regulations on the taxation of fringe benefits. Within the past few years, efforts by the Treasury Department and the Internal Revenue Service to establish an exhaustive regulatory scheme governing fringe benefits created both conflict and chaos. A current proposal by a Treasury Department official that his Department take a crack at enumerating all taxable fringe benefits through the regulatory process promises more of the same. It is time to recognize that employee fringe benefits, with only limited exception, should not be subject to taxation.

Employees in the electric utility industry, as in other industries, are recipients of various fringe benefits which have been offered them as a matter of business convenience or necessity, and which have long been properly regarded as nontaxable to the employees. We believe that it would be a

mistake to treat the bulk of these benefits as taxable income, for such treatment would subvert well-recognized justifications for their non-taxable status and would unjustly penalize the employee-recipients. Moreover, non-taxable status would in numerous instances support other Federal policies as well --policies which give recognition to the evolution of collectively bargained benefits, to affirmative action programs for disadvantaged minorities, and to the need for increased health and safety in the work environment.

At the outset, it is important to keep in mind the limited nature of the fringe benefits under discussion. The scope of the issue has been seriously exaggerated by reports that fringe benefits may amount to as much as 35 to 40 percent over and above wages. What is lost sight of, however, is that the vast bulk of that figure is attributable to such fringes as pension ard insurance plans and the like--matters which already are covered by statute and are not in controversy. To put the matter in proper perspective, fringe benefits in our judgment should be divided into four main categories, as follows:

A. Legally required benefits. These include F.I.C.A., Unemployment Compensation, and Workers' Compensation.

B. Health/Life benefits and paid time off. The health benefits include long-term disability, group life insurance, and group sickness, accident and hospitalization insurance. The paid time off includes vacation, holiday, personal leave,

funeral leave, sick leave, and jury duty. It is important to note that paid time off does not constitute additional compensation over and above regular earnings, but rather prevention of loss of earnings for unworked time. Such paid time off for tax purposes is generally treated as compensation and is taxed as regular income.

C. Benefits subject to deferred taxation. These include pension or profit-sharing plans, ESOP's, thrift savings plans.

D. Other benefits. These include use of company vehicles, physical examinations, free parking on the employer's premises, meals reimbursement for overtime or emergency work, employer subsidized cafeterias, company picnics and Christmas parties, and the like. Although we simply would not view on-the-job training as a fringe benefit at all, such training if treated as a fringe benefit would fall in Group D.

In response to a 1978 request by the House Ways and Means Committee Task Force on Employee Fringe Benefits, EEI surveyed its membership in an effort to measure the nature and scope of fringe benefits in the electric utility industry. The results are revealing. On the basis of that survey, EEI estimates that the cost of fringe benefits, if defined to include <u>all</u> items in Groups A, B, C and D, amounts to approximately 40.31 percent of the average employee's straight-time earnings. If fringe benefits are more properly defined as all items in Group D alone, that proportion shrinks dramatically from 40.31 percent to 6.14 percent. The following chart shows the breakdown of the four groups and their components:

	% of straight-time payroll	
Group A (F.I.C.A., Unemployment Compensation, Workers' Compensation)	6.70	
Group B	17.75	
Long-term disability		1.01
Group life		1.20
Group health		3.70
Paid time off		12.84
Group C	9.72	
Pension		9.72
Other		Negligible
Group D (Other Benefits)	6.14	
	40.31	

It is to this limited area of "Group D" benefits that S. 224 is directed.

There is no sound reason why, given appropriate safeguards, fringe benefits should be treated as taxable income to the employee at all. This is so because, in line with well-established precedent as we discuss below, the proper focus of attention should be upon the benefit to the employer. In the view of EEI, the affirmative answer to either of two questions should be determinative:

(1) Is the benefit primarily for the convenience of the employer?

(2) Is the benefit essential to the operation of the business?

If either of the questions is answered in the affirmative, the benefit in issue should not be treated as taxable income to the employee. To be sure, if the benefit were to be used as a tool for discrimination, it should remain fully taxable. But such

discriminatorily imposed benefits would in any event be violative of other Federal laws, such as Civil Rights Laws, and would presumably be invalidated under those statutes.

The "convenience" and "essentiality" standards that we believe should govern are not new and have a proven history. As early as 1920 the Treasury Department exempted supper money paid to employees who worked overtime because such money was paid for the convenience of the employer (O.D. 514, 2 Cum. Bull. 90, June 1920). Numerous other employee benefits fall within the "convenience of the employer" standard. Many companies provide subsidized cafeteria operations, and do so for reasons of their own self-interest. A variety of factors may influence such a company decision. The lunch period may be too short to enable employees to purchase their meals elsewhere; there may be a need or desire to keep the employees close to the worksite; or there may not be suitable eating facilities within a feasible distance from the plant. In all such cases, although to be sure the employee has benefited, it is the convenience of the employer that is being served. Free parking at the plant for employees similarly serves the employer's convenience, for by that device he helps assure the punctuality of employees, and their orderly entrance to and exit from the plant. Obviously a variety of other benefits fall into this category.

A number of common benefits must be regarded as "essential to the operation of the business." An example of particular

importance to the electric utility industry is the extensive and continuing program of on-the-job training for employees. Although pronouncements from IRS and Treasury have been far from consistent, they have given rise to concern in our industry that on-the-job training might be viewed as a taxable benefit. Ours is an industry which requires a high degree of technical competence on the part of our employees in order to keep up with the rapidly changing technology and to master highly complex equipment. A line crew member of an electric utility company, as well as members of the other crafts, must stay abreast of the latest advances in sophisticated equipment if he is to perform his job properly and effectively.

Virtually every employee, if he is to perform well and be able to progress in his work, should be exposed to such on-the-job training, whether it takes place at the worksite or at a specialized school. In the context of government-mandated or voluntary affirmative action programs, such training takes on an added value for disadvantaged minorities, for whom it provides not only a path of entry into the job market, but also an avenue to upward mobility in the actual workplace.

Also, the line crew members in particular are exposed to a variety of on-the-job hazards--exposure to live wires, climbing to dangerous heights, the dangers present in working underground. Among the very real purposes of on-the-job training

is to increase awareness of safety hazards, and to make employees sensitive to safety precautions that must be undertaken for their own well-being. Under such circumstances it would be senseless to view on-the-job training programs as anything other than "essential to the operation of the business." Moreover, it is obvious that such programs are not only in the best interest of the affected employer and employees, but in many cases may well be necessary to ensure compliance with specific Federal statutes, such as the Occupational Safety and Health Act.

One general point is worth further emphasis in connection with benefits "essential to the operation of a business." Particularly in recent years there has been an increasing, and proper, Federal interest in the safety and health of citizens, and specifically, through the Occupational Safety and Health Act, in the safety and health of employees. Benefits designed to monitor and improve the health and safety of employees can properly be regarded as benefits accruing to the employer (as well as to the employees) under the standards outlined above, and should not be taxed to the employees.

In the same category of "essential to the operation of a business" is the use of employer-owned vehicles by employees in the electric utility industry. As we are all painfully aware, severe storms or power outages which can occur for other reasons can create havoc in a community, and it is vital for employees

to respond quickly and efficiently. Needless to say, employees are expected to report to their jobs immediately. Through the use of company vehicles equipped with two-way radios, employees and equipment can be dispatched where needed without delay.

A wholly different area, though of minor scope in the electric utility industry, serves to illustrate both the "convenience of the employer" standard and the potential disruption to the collective bargaining process if the fringe benefits in issue were to be taxed. A small minority of EEI members grant a discount to their employees for residential electric service, which may well be memorialized in a collective bargaining agreement. In other industries, concessions to employees based upon the employer's product--be it a telephone discount, free transportation for airline or railroad employees, a reduced price for the merchandise of a retail employee--have become a vital part of the employee's economic package and, where collectively bargained, have been calculated for cost-benefit purposes on the basis of their non-taxable status. As a union official stated in testimony before the Task Force of the Committee on Ways and Means:[1/]

> "Since the beginning of the labor movement, workers have been allowed certain fringe benefits directly related to and specifically designed to stimulate that worker's overall productivity. The coal miner was allowed to fill his pockets with coal for home use; the railroad worker rode the trains for free, and the telephone worker was given the free use of a telephone."

1/Testimony of Louis B. Knecht, Secretary-Treasurer, Communications Workers of America, AFL-CIO, Hearings, p. 138.

The same considerations hold true for a variety of long-accepted benefits, such as free parking on the employer's premises, meals reimbursement for overtime or emergency work, and of course many others.

Fringe benefits have become part of the quid pro quo in bargaining an economic package. Plainly, any change in their non-taxable status would have serious consequences at the bargaining table. In these inflationary times which have already put collective bargaining to the test, any further complications at the bargaining table would be unacceptably destructive.

We believe that the two alternative tests--benefits primarily for the convenience of the employer, and benefits essential to the operation of a business--constitute the proper yardstick by which the non-taxability of employee fringe benefits can be measured. The standard must be a general one in order to provide a useable guideline but also retain the flexibility needed to assess individual cases.

In this context a recent suggestion by the Treasury Department would surely court disaster. During the September 17 hearing before the Subcommittee, Assistant Secretary Donald Lubick stated that the IRS would like to undertake the project of determining which fringe benefits should be taxed and enumerating them in a proposed regulation. The prospect of cataloguing the myriad of fringe benefits in the industrial sector is mind-boggling. To attempt to assess each fringe benefit with its

infinite number of variations in order to establish a detailed regulatory scheme would be enormously wasteful and unproductive. Indeed, the Treasury Department's proposal in effect invites the Congress to lose itself in the impenetrable thicket of reviewing and legislating upon each benefit enumerated in a new battery of regulations.

S. 224 would prevent any such disruptive regulatory framework. The bar on new regulations would assure that arbitrary standards could not be invoked to impose tax liability upon employee fringe benefits.

STATEMENT OF

J. R. SNYDER

ON BEHALF OF

THE RAILWAY LABOR EXECUTIVES' ASSOCIATION

My name is J. R. Snyder. I am the Chairman of the Legislative Committee of the Railway Labor Executives' Association and the National Legislative Director of the United Transportation Union. I have prepared this statement on behalf of the RLEA in support of S 244. I am submitting it to the Committee in response to the invitation of the chairman with the request that it be incorporated into the hearings record on this bill.

The RLEA is an association of standard and of international railway labor organization, 21 in number, whose function is to promote the common interests and welfare of railroad employees and their families. These 21 organizations collectively represent virtually all of the organized workforce employed by railroads in this country. I have listed the names of these organizations in the attachment of this statement in accordance with the Senate rules.

S 244 would continue indefinitely the provisions in P.L. 95-427 which prohibits the issuance of regulations, taxing fringe benefits. P.L. 95-427 was the legislature's response to a movement within the Treasury Department to reverse a long standing policy covering the non-taxability of a wide range of fringe benefits affecting employees in a broad catagory of industries, including the railroad industry. The proposal to reverse this policy first appeared, so far as we know, in a discussion draft of proposed regulations issued by the Treasury Department during the last days of the Ford Administration. The railroad labor organizations through the RLEA responded to this discussion draft in early 1976 with strenuous objections to the program to extend the tax to cover functions which have never been

subject to the Internal Revenue laws and which should remain non-taxable.

We pointed out to the Treasury at that time that its proposal would disrupt the common practice throughout the railroad industry to require signalmen to have their off-track vehicles available at all times whether on or off duty. The requirement of around-the-clock availability means that the signalmen drive their repair trucks to and from their work stations as a regular practice. These men may be called upon at any hour of the day or night to respond to an emergency within the jurisdiction of their craft and it is therefore essential that they have transportation available to them at all times for immediate action. The Treasury discussion draft of 1975 was sufficiently broad enough to have required the quantification of the value of the use of these emergency trucks to and from work. The proposition that a dollar value should be placed upon a job requirement of this kind and that a tax based upon the formula established by the Internal Revenue Service should be imposed upon every signalmen who uses this emergency equipment, appears to us to be altogether unreasonable and disruptive and we so informed the Treasury Department in early 1976.

There are, of course, other examples of railroad employees who may personally use equipment of this nature for employment-related purposes.

Off track vehicle insurance, railroad passes, meal and lodging allowances and insurance are among other functions which would have been made subject to the Internal Revenue laws by the 1975 Treasury discussion draft.

53-845 O - 79 - 49

There are many other examples to which Senator Hatch adverted in his testimony and which other witnesses before this Committee identified and we are in complete agreement with the views expressed by these witnesses that any change in the practices with respect to the taxability of function of this kind should remain the responsibility of the Congress.

We join the sponsoring Senators in urging favorable action by this Committee on this bill.

APPENDIX

1) American Railway Supervisors Assn.

2) American Train Dispatchers Assn.

3) Brotherhood of Locomotive Engineers

4) Brotherhood of Maintenance of Way Employes

5) Brotherhood of Railroad Signalmen

6) Brotherhood of Railway Carmen of the United States and Canada

7) Brotherhood of Railway, Airline and Steamship Clerks, Freight Handlers, Express and Station Employes

8) Brotherhood of Sleeping Car Porters

9) Hotel & Restaurant Employes & Bartenders Int'l. Union

10) Int'l. Assn. of Machinists and Aerospace Workers

11) Int'l. Brotherhood of Boilermakers and Blacksmiths

12) Int'l. Brotherhood of Electrical Workers

13) Int'l. Brotherhood of Firemen & Oilers

14) Int'l. Org. of Masters, Mates & Pilots of America

15) Nat'l. Marine Engineers' Beneficial Assn.

16) Railroad Yardmasters of America

17) Railway Employes Dept., AFL-CIO

18) Sheet Metal Workers' Int'l. Assn.

19) Seafarers Int'l. Union of North America

20) Transport Workers Union of America

21) United Transportation Union

STATEMENT OF RICHARD HUNT ON BEHALF OF
THE INTERNATIONAL TAXICAB ASSOCIATION
BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY
CONCERNING LEGISLATIVE PROPOSALS RELATING TO
"INDEPENDENT CONTRACTORS"
OCTOBER 11, 1979

Mr. Chairman, my name is Richard Hunt. I am President of Indianapolis Yellow Cab Company, Indianapolis, Indiana and President of the International Taxicab Association. I am appearing before you today on behalf of the association, which is the sole trade association in the taxicab industry, representing taxicab operators in every state and in all major cities in the United States.

The taxicab industry has used the lease system of operation, where the IRS determines the driver to be an independent contractor, since the 1930s. Small southern taxicab companies were the first to switch to leasing to avoid going bandrupt.

In a lease operation, the driver (independent contractor) pays a fee based on hours of vehicle use and number of miles traveled. This "Hertz-type" lease significantly reduced the administration burden and related costs to the small southern companies. As a result these companies were able to make a reasonable profit, the lessees (independent contractors) made more money, and the public received better service.

Leasing has evolved to the point where 30% of all taxicab companies operate under a lease system. Companies in 47 of the 50 largest cities in the U. S. use a lease system. Apart from the reduction of governmentally-imposed

administrative costs, the operation of a taxicab fleet through a leasing system holds numerous practical advantages for the company, the driver, and the public. Under the old "commission" system, in which the driver is treated as an employee, the fares collected by the driver are "split" on a percentage basis between the driver and the company. That system requires the company to collect all fares from the driver, make deductions for withholding, social security, and unemployment taxes as well as a number of internal bookkeeping entries, and then redistribute the driver's share to him in the form of a paycheck. In contrast, the lease system relieves the company of the necessity of redistributing the fares collected. The company takes its revenues solely from a lease fee, collected from the driver on a daily or weekly basis. The driver then retains all fares and tips he collects. The company issues no payments to independent contractor drivers.

The administrative savings for the taxicab company, generally between 25 and 30%, and the increased earnings for the drivers are essential to achieving the end result of better service to the public. The level of service is increased by the following factors:

1. The independent contractor driver does not split his fares with the company, therefore, to increase his revenue he responds more quickly to calls and is able to handle more calls.
2. Because the driver keeps everything he earns, fare and tip, he is generally more courteous to the passengers.
3. The company, by reducing its administrative expense, keeps its fare structure lower than would otherwise be possible.
4. Lease drivers prefer to lease newer cars which are more appealing to their customers and increases their revenue. Lease companies must respond to the drivers demand for newer equipment.

5. Lease drivers, unlike driver employees, are responsible for purchasing their fuel. This further supports their desire for newer more fuel efficient cars. It has also resulted in lease drivers consuming 12% less fuel than commission drivers.

I would like to take a moment to describe to you who the "public" is that the taxicab industry transports. Currently, 60% of all taxicab trips are taken by transportation disadvantaged persons. The term "transportation disadvantaged persons" applies to the elderly, handicapped, unemployed, housewives, and other persons who do not have ready access to public or private transportation. Persons age 60 and over represent 10.5% of the national population for incorporate areas but account for 25.5% of all taxicab trips. These transportation disadvantaged persons are generally low income and often taxi-dependent.

Now that I have outlined the way that leasing works within the taxicab industry I would like to offer some thoughts on what would happen if the status of independent contractor were taken away from taxi drivers. First, taxi fares would have to immediately increase approximately 21% to cover the direct increase in costs the company would experience. Second, even with the increase fares the taxi drivers would, in most cases, experience a decrease in income. Third, 60% of the taxi industry's passengers would face a mobility crisis due to increase taxi fares. Fourth, due to the resistance of the governing body to grant taxi fare increases numerous taxicab companies would go out of business, thereby further increasing the mobility crisis of taxi-indendent passengers.

The IRS claiming tax evasion by people operating as independent contractors, wants companies to withhold 10% of the earnings of independent contractors.

I do not know how a taxicab company that operates under a lease system could comply. The lessee (independent contractor) pays a fee to the company for the vehicle and services. The taxicab company does not know what the driver earns in fares and tips and makes no payments to the driver. The independent contractor's earnings from the numerous passengers he has serviced are know only to the driver. Therefore, IRS's position in no way takes into account the taxicab industry's mode of operation.

For the reasons outlined above the International Taxicab Association wholeheartly supports the legislation that has been introduced by Senator Dole and Representative Gephardt (S. 736 and H. R. 3245) to simplify the test of employment status. We support the Dole-Gephardt bill, because it provides clear-cut objective standards for determining employment status. The enactment of objective standards is necessary at this time to eliminate the possibility of subjective or discriminatory determinations of employment status. Therefore, we urge this subcommittee to favorably report the Dole-Gephardt bill.

JIM MALOOF/REALTOR®

[illegible] NORTH KNOXVILLE AVENUE / PEORIA, ILLINOIS [illegible] / TELEPHONE [illegible]

October 9, 1979

Senator Harry S. Byrd, Jr.
133 Russell Building
Washington, D.C. 20510

RE: Senate Finance Subcommittee on Taxation and Debt Management

Dear Senator Byrd:

We are the largest real estate company in Peoria, Illinois with 90 employees. I totally disagree with the intent of the testimony of Dr. Jack Carlson, Executive Vice President of the National Association of REALTORS®.

We converted our entire sales staff from independent contractors to employees in 1977. We believe in this move even at the nominal expense of additional bookkeeping, and the major expense of the additional F.I.C.A. tax. But many other real estate brokers disagree, not because real estate sales people are actually "independent contractors", but as a long standing, archaic approach of doing business cheaply, and to minimize their responsibility to the consumers we serve.

Independent contractor status is damaging to our profession and unfair to us who must compete with those firms.

Very truly yours,

JIM MALOOF/REALTOR®

Michael Maloof
Executive Vice President

MM/dm

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ATLANTA, GEORGIA 30303
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October 15, 1979

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Statement on Behalf of the National Association <u>of Life Companies on S. 736 and Related Proposals</u>

Dear Mr. Chairman:

On behalf of the National Association of Life Companies (NALC), we submit the enclosed statement for inclusion in the record of the Subcommittee's September 17, 1979, hearing on certain miscellaneous tax bills, including S. 736. That bill, which is sponsored by Senators Dole, DeConcini, and Matsunaga would clarify the standards used in determining whether, for federal employment tax purposes, individuals are independent contractors or employees.

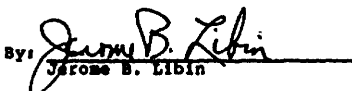
The NALC, whose membership includes over 300 life insurance companies representing 400,000 shareholders and 60 million policyholders in more than 40 states, applauds the Subcommittee's consideration of the knotty issues raised by Senator Dole's bill. S. 736 would bring some measure of clarity and predictability to an area where certainty has long been absent, and the NALC strongly recommends enactment of the bill.

At the same time, the NALC vigorously opposes the Treasury Department's proposal to require withholding on payments to independent contractors. That proposal completely fails to address the fundamental question of status -- of whether an individual is to be treated as an independent contractor or an employee. Thus, it would do nothing to end the confusion that taxpayers have faced in this area for almost a decade. In addition, in coming forward with its proposal, the Treasury has grossly understated the costs and administrative burdens that would accompany withholding. Perhaps most important, the Treasury has utterly failed, at least with respect to the insurance industry, to demonstrate the need for a solution as radical as withholding. The NALC submits that this fact, coupled with the availability of less drastic means of addressing any compliance problems that may exist, requires that the Treasury's withholding proposal be rejected.

The enclosed statement sets forth the NALC's position in detail.

Respectfully submitted,

SUTHERLAND, ASBILL & BRENNAN



By: Jerome B. Libin

Timothy J. McCormally

Statement of
Sutherland, Asbill & Brennan,
Washington, D.C., on Behalf of
the National Association of Life Companies
on S. 736 and Related Proposals

This statement is submitted on behalf of the National Association of Life Companies (NALC), an association of over 300 life insurance companies. The NALC, whose principal office is in Atlanta, Georgia, was organized in 1955, and its members are active in more than 40 states, Puerto Rico, and Canada, represent more than 60 million policyholders, and have over 400,000 shareholders and 170,000 employees.

The NALC urges the Subcommittee on Taxation and Debt Management to act favorably on S. 736, the independent contractor tax bill introduced by Senator Dole of Kansas. That bill represents a reasonable and balanced approach to a problem that has long existed in the employment tax area -- the question of what standards should be used in distinguishing independent contractors from employees. At the same time, the NALC wishes to voice its opposition to the proposal offered by the Treasury Department to require withholding on payments made to independent contractors. Not only does the Treasury proposal fail to address the central issue before the Subcommittee -- the status question -- but it is also ill-conceived. Although the stated goal of the Treasury proposal is to increase income and Social Security tax compliance, the proposal is so riddled with exemptions that the principal industries that would be subject to

withholding are the industries, most notably the insurance industry, whose compliance rates are the highest; industries with the lowest compliance rates would paradoxically be exempt. In addition, the ease of administering the withholding program has been as exaggerated as the costs and burdens of the program have been understated. The Treasury Department's proposal, therefore, should be rejected outright.

I. The History of the Problem

Since the inception of the Social Security system in 1935 and the imposition of income tax withholding at the source in 1943, the question of who is and who is not an independent contractor has been answered, with limited statutory exceptions, by reference to the common law control test. That test focuses on whether the person for whom an individual performs services has the right to control not only the results to be accomplished but also the details and means by which those results are accomplished. If the person possesses that control, regardless of whether it is exercised, the individual will be treated as an employee; if that control is absent, the individual will be treated as an independent contractor.

For years application of the common law control test to the insurance industry caused few problems: insurance companies treated their commission sales agents as independent

contractors,*/ and that treatment was accepted and sanctioned by the Internal Revenue Service. See G.C.M. 18705, 1937-2 C.B. 379; S.S.T. 249, 1938-1 C.B. 393; Rev. Rul. 54-309, 1954-2 C.B. 261; Rev. Rul. 54-312, 1954-2 C.B. 327; Rev. Rul. 59-103, 1959-1 C.B. 259; Rev. Rul. 69-287, 1969-1 C.B. 257; Rev. Rul. 69-288, 1969-1 C.B. 258. The courts similarly upheld the traditional treatment of insurance agents as independent contractors. See Reserve National Insurance Co. v. United States, 74-1 U.S. Tax Cas. ¶ 9486 (W.D. Okla. 1974); Standard Life & Accident Insurance Co. v. United States, 75-1 U.S. Tax Cas. ¶ 9352 (W.D. Okla. 1975); Kelbern M. Simpson, 64 T.C. 947 (1975). The independent contractor status of insurance agents was most recently affirmed in a case involving one of the NALC's member companies. See Investors Heritage Life Insurance Co. v. United States, 79-1 U.S. Tax Cas. ¶ 9394 (E.D. Ky. 1979), accepting and adopting magistrate's report and recommendations, 79-1 U.S. Tax Cas. ¶ 9246 (E.D. Ky. 1979).

As the Subcommittee is well aware, notwithstanding this long line of authority in the early 1970s, the Internal Revenue Service (IRS) reinterpreted the common law test and

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*/ This is not to say, however, that all insurance agents are independent contractors. Some insurance companies choose to exercise substantial control over their agents' activities and, accordingly, treat their agents as employees.

concluded -- not in any published ruling or pronouncement but in the course of employment tax audits -- that commission insurance agents, among others, should be treated as employees. As a result of the reclassifications, the IRS proposed massive assessments against taxpayers in many industries, assessments that were made even though the IRS had long accepted the taxpayers' treatment of the individuals involved as independent contractors and even though (in at least one insurance company case) the IRS had issued favorable "technical advice" in respect of the taxpayer's agents for the very year with respect to which the assessment was proposed.

The IRS's reclassification program, in short, produced chaos, and confusion reigned where certainty once ruled. Taxpayers in several industries turned to Congress for help, and in 1978 it interceded: it passed section 530 of the Revenue Act of 1978. Section 530 not only provided relief from the staggering retroactive assessments, but it also prohibits the IRS (until December 31, 1979) from reclassifying traditional independent contractors as employees. The relief accorded by section 530, however, is only interim relief: the moratorium on reclassifications expires at the end of this year. Congress must now formulate and enact a permanent legislative solution. S. 736 is such a solution, and the NALC recommends its prompt enactment.

II. S. 736 Represents a Reasonable and Balanced Approach to the Status Question

S. 736 was introduced by Senator Dole, who last year introduced the bill that was ultimately enacted as section 530 of the Revenue Act of 1978. The bill, which is cosponsored by Senators DeConcini and Matsunaga, promises to bring order and a measure of clarity to an area where certainty has long been absent. S. 736 and its companion measure in the House of Representatives (H.R. 3245, which was introduced by Representative Richard Gephardt of Missouri and which has the bipartisan support of more than 130 members of the House) would establish several "safe harbor" requirements that, if satisfied, would result in an individual's being presumed to be an independent contractor.*/ The approach of S. 736 is balanced, well-reasoned, and fair.

From the NALC's perspective, the most important aspect of S. 736 is its focus: the bill forthrightly addresses the question of status -- of what standards are to be used in determining who is and who is not an independent contractor. That any legislation in this area should address the status

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*/ The principal difference between S. 736 and H.R. 3245 is the inclusion in the House bill of a specific "no inference" provision. That provision states that, if an individual fails to qualify as an independent contractor under the bill, no inference is to be drawn about the individual's status as an employee; rather, his status is to be determined under the common law control test. The NALC supports the concept of a "no inference" provision and recommends that S. 736 be amended to include such a provision.

issue might at first blush seem obvious. After all, the root of the problem has long been considered to be the IRS's reinterpretation of the common law control test, its reclassification as employees of thousands of traditional independent contractors. Indeed, it was the IRS's reinterpretation of the common law test that spawned the audits, the lawsuits, and ultimately the legislation Congress passed last year. But the need to address the status issue -- the obvious -- has apparently escaped the Treasury Department, for it has come forward with a proposal that would do nothing to clarify the status issue. The NALC submits the Treasury's approach of leaving the common law control test intact, without clarification, is unacceptable.

By focusing on the status question, S. 736 will afford taxpayers the certainty and predictability they need to plan and conduct their business affairs. The bill will not only preserve the status of thousands of individuals who have historically been treated as independent contractors, but it will also effectively limit the IRS's ability to arbitrarily and unfairly reclassify such individuals as employees. Such a limitation on the IRS's discretion in this area is necessary in light of the experience of the last 10 years.

S. 736 contains a five-factor "safe harbor" test that can be easily applied. If all five of the bill's requirements are satisfied, the individual whose status is in question will

be treated as an independent contractor. The bill, however, is not a loose, "something for everybody" bill. It distills the essence of the common law control test, and individuals who are common law employees will not be able to satisfy all of the bill's five tests. Indeed, the "safe harbor" approach of the bill is necessary because many individuals who are undeniably independent contractors -- plumbers, doctors, lawyers -- will be unable to satisfy all the "safe harbor" requirements. Nevertheless, with respect to those industries in which the line between independent contractors and employees has become blurred, those industries in the so-called "gray areas," the "safe harbor" tests will represent a vast improvement over the common law control test.

Two of S. 736's five tests -- the written-contract-and-notice-of-tax-responsibilities test and the filing-of-required-returns test -- will be comparatively easy to apply: either the tests will be satisfied or they will not. Moreover, by requiring that the individual's contract be written and that it specify his tax responsibilities as an independent contractor, the bill should enhance compliance with the tax laws. The bill's other three tests -- the control-of-hours, place-of-business, and investment-or-income-fluctuation tests -- focus on the essence of control: whether the individual controls when he works, how long and hard he works, and where he works; and whether the amount of money an individual earns

is determined not by the mere number of hours he works but by what he produces and how much he invests.

In his written statement to the Subcommittee, Donald Lubick, Assistant Secretary of the Treasury, leveled three criticisms at S. 736: first, that it affords protection to all individuals in the so-called "gray areas"; secondly, that it will overturn numerous court cases and will result in numerous employees' being treated as independent contractors; and thirdly, that it will be "complex to apply." Those criticisms are groundless.

The first criticism -- that the bill will afford "safe harbor" protection to all the classes of individuals whose status as independent contractors has been questioned by the IRS -- is, first and foremost, simply not true. Entitlement to "safe harbor" protection under S. 736 is not automatic, and several classes of individuals who in the past have been treated as independent contractors -- and whose status as such has been challenged -- will be unable to satisfy the bill's five tests. For example, many insurance companies have long engaged in the practice of "financing" their new agents, of guaranteeing to a limited extent their income during their first few months. Although some companies have long treated these "financed" agents as independent contractors, the agents will not fall within S. 736's "safe harbor"; they will be unable to satisfy the investment-or-income-fluctuation test. Equally important, in criticizing the bill as providing

"safe harbor" protection for individuals in the "gray areas," the Treasury has failed to recognize that the IRS's challenging an individual's status as an independent contractor does not transform that individual into an employee. Indeed, a review of the litigated cases reveals that the IRS has lost many more reclassification cases in the "gray areas" than it has won. S. 736 will do no more than preserve the independent contractor status of individuals who have long enjoyed that status. It will do no more than prevent the IRS from arbitrarily reclassifying such individuals as employees.

The Treasury's second criticism -- that the bill will result in numerous employees' being treated as independent contractors -- is equally without merit. It cannot be gainsaid that many employees could satisfy one, two, or possibly three of the bill's five "safe harbor" requirements. There is absolutely no evidence to suggest, however, that large classes of employees could or would be "switched" to independent contractor status. In order to satisfy all five of S. 736's tests, a company would have to fundamentally alter its relationships with the individuals involved, to make changes most would be unable or unwilling to make. In other words, the "switching" argument is supported more by rhetoric than reason.

The Treasury's final criticism of S. 736 -- that it will be complex to apply -- is curious indeed. One of the virtues of the bill is that it will limit the inquiry to be made.

Unlike the common law control test which is to be interpreted by reference to 20 different factors -- many of which may not even apply in a particular case -- S. 736 will require consideration of only five tests. It is simply preposterous to suggest that S. 736 will be more difficult to interpret and apply than the common law control test. The criticism is doubly perplexing in light of the Treasury's own proposal, which not only would give rise to a plethora of forms and exemption certificates but would also leave the classification issue unanswered. (The Treasury's withholding is discussed in detail below.)

In sum, S. 736 and the "safe harbor" approach it embodies represent a vast improvement over the common law control test. The bill will bring order out of the chaos the IRS's reclassification program produced. It should promptly be enacted.

III. The Treasury's Withholding Proposal Should Be Rejected

The NALC believes it is absolutely imperative that Congress take up and resolve the status issue. Without guidance from Congress on this question, the type of guidance accorded by S. 736, taxpayers will be unable to effectively plan and conduct their business affairs. Notwithstanding the need for guidance and fact that the problems in this area can be traced directly to the IRS's reinterpretation of the common law control test, the Department of the Treasury has proposed to do nothing about the status question. Instead, the Treasury

would subject payments to independent contractors to flat rate (10 percent) withholding. The status question, however, would remain important under the Treasury's proposal: taxpayers would have to determine which withholding system their workers fell within.

The NALC strongly opposes to the Treasury's proposal. The failure of the Treasury proposal to address the fundamental issue of status alone warrants its rejection. There are other, perhaps more compelling reasons, however, for not requiring withholding on independent contractors. The Treasury's proposal would be extremely difficult, if not impossible, to apply. Perhaps most significantly, the proposal would not accomplish the goal the Treasury has set for it: it would not significantly increase compliance with the tax laws.

As previously stated, the withholding proposal would be extremely difficult to apply. With respect to the insurance industry, for example, the obligation to withhold -- to file forms, to complete reports, to remit withheld funds -- would extend far beyond a company's obligation to withhold on payments to its selling agents. Companies would potentially have to withhold on lawyers (who defended claims), doctors (who conducted physical examinations), and all other independent contractors it paid in the course of its business (for example, accountants, plumbers, and electricians). Some of those individuals would undeniably qualify for exemption under the Trea-

sury's five-or-more-payor or overwithholding exemptions. But not all of them would be exempt. Moreover, as explained by Assistant Secretary Lubick, the exemption would have to be elected by the individuals involved -- the payees; and some of the individuals qualifying for exemption might choose not to file exemption certificates with the company. In this regard, too, it should be noted that some insurance agents could qualify for exemption; whether they could, or would elect to, qualify for exemption, however, would not reduce or eliminate the need for a company to have the resources and capability to withhold. Indeed, that some agents might be exempt and others might not be would only compound the complexity of withholding.

The paperwork generated by the exemption process would obviously be quite substantial. But the burden of withholding would go far beyond the paperwork. The withholding obligation on payments to independent contractors would be a recurring one and would thus be significantly more burdensome than mere information reporting. Currently, companies are required to file information returns annually and then only in respect of aggregate payments of $600 or more. Withholding, in contrast, would be required every time a payment, however small, was made to an independent contractor. That burden would be tremendous. Indeed, if an insurance company remunerated its agents on a policy-to-policy basis (that is to say, each time an agent submitted an application for insurance, the company

would send the agent his commission on that policy), it would likely be withholding on a daily basis. Moreover, the argument that the cost of withholding would be offset by the company's "use" of the withheld funds proves too much, for the monies withheld in most cases would have to be remitted within three days of the date on which they were withheld. (See Treas. Reg. § 1.6302-2(a).) In short, withholding would entail much more than merely multiplying the payment made to an independent contractor by .1 and withholding and remitting that amount to the Government. To suggest otherwise reflects, at best, a misunderstanding of the mechanics of withholding and, at worst, a high degree of disingenuousness.

The fundamental flaw in the Treasury's proposal, however, lies not in its gross understatement of the costs and burdens of withholding but rather in the fact that the proposal would not achieve its stated goal: it would not significantly increase compliance. The Treasury's withholding proposal is premised on a finding of significant non-compliance among independent contractors performing services in several industries. That finding is not beyond dispute, for the IRS compliance study from which it was drawn suffers many defects: among other things the sample studied was too small and unrepresentative; the study measured not tax compliance but rather whether compensation was reported; and no correlation was drawn between the filing of information returns and compliance. But even assuming the re-

sults of the compliance study were valid, that a significant compliance problem existed, the Treasury proposal would not solve it. Equally important, there are less burdensome ways in which the problem could be addressed.

Preliminarily, it should be noted that, during the Subcommittee's hearing on this issue, Assistant Secretary Lubick acknowledged that the insurance industry had a significantly higher compliance rate than other industries. In his written statement, however, he said, "* * * [N]oncompliance rates do not have much to do with the industry classification of the worker." His oral testimony was closer to the mark: whereas overall income tax non-compliance was found to be 47 percent, in the insurance industry over 98 percent of the compensation paid was reported, and only 6.2 percent of the individuals were found to be in "zero compliance." The extremely high compliance rate in the insurance industry by itself, of course, is neither surprising nor remarkable, for the industry has voluntarily taken steps to aid compliance; for example, although they are not required to do so by law, most insurance companies furnish copies of Forms 1099 to their selling agents.*/

*/ As noted above, one of the most obvious flaws in the IRS compliance study was its failure to correlate the furnishing of Forms 1099 with compliance. The NALC is confident a strong correlation between the two exists and that requiring companies to furnish copies of the information returns to the independent contractors would increase compliance.

What is remarkable is that in formulating its withholding proposal the Treasury has failed to give due consideration to the insurance industry's high compliance rate. That is not to say, however, that the Treasury has not accorded the insurance industry -- and, indeed, the other industries that fared well in the compliance study -- a special status. It has. The Treasury has in effect proposed to withhold only on individuals in those industries that have a high level of tax compliance. Its proposal, as a practical matter, would exempt from the withholding obligation those industries with the lowest compliance rates. For example, workers in the trucking (54.2 percent "zero compliance"), logging (69.5 percent "zero compliance"), real estate construction (63.7 percent "zero compliance"), and home improvement (55.5 percent "zero compliance") industries most likely would all be able to qualify for either the five-or-more-payor or the overwitholding exemption. At the same time, the industries with the highest compliance rates -- insurance (98.3 percent of the compensation reported) and real estate (89.5 percent of the compensation reported) -- would be burdened with the costs and administrative complexities of withholding.*/

*/ It should be noted that a withholding proposal that was recently introduced in the House (H.R. 5460) would expand the concept of exempting those industries with high levels of non-compliance. That bill would add a third exemption to the two proposed by the Treasury: no withholding would be required in respect of "qualified direct sales." The "zero compliance rate" in the direct selling industry was found to be 43.3 percent.

The net effect of the withholding proposal and its exemptions would thus be this: withholding would be imposed only on those industries in which no significant compliance problem exists.

That the Treasury's proposal would reach primarily those industries with high compliance should alone lead the Subcommittee to reject it. There is, however, another, almost as compelling, reason: compliance -- the Treasury's stated goal -- can most likely be enhanced through means less radical and less burdensome than withholding. The NALC submits that increased compliance can be obtained by strengthening current information reporting requirements; specificially, by requiring both that taxpayers furnish copies of the information returns (Forms 1099) to their independent contractors and that the independent contractors attach those forms to their income tax returns. It is no mere coincidence that the insurance and real estate industries have the highest compliance rates: companies in both those industries have voluntarily undertaken the burden of sending the Forms 1099 to their independent contractors. Requiring all companies -- including those doing business on a buy-sell or deposit-commission basis -- to furnish their independent contractors with information returns (and increasing the penalties for failing to comply with information reporting requirements), the NALC believes, would demonstrably increase compliance. The NALC urges the Subcommittee to consider carefully

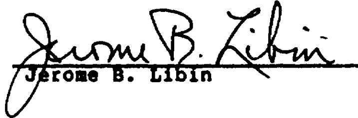
this alternative course, for it could achieve the Treasury's goal at a fraction of the cost and complexity of withholding.

IV. Conclusion

The NALC urges the Subcommitee to respond positively to the need to clarify the standards used in determining whether an individual is or is not an independent contractor by acting favorably on S. 736. The NALC also recommends that the Subcommittee reject outright the Treasury's proposal for withholding on independent contractors, opting instead to strengthen current information reporting requirements.

Respectfully submitted,

SUTHERLAND, ASBILL & BRENNAN

By: 
Jerome B. Libin

Timothy J. McCormally

Counsel for the National Association of Life Companies

STATEMENT OF THE

HEALTH INSURANCE ASSOCIATION OF AMERICA

The purpose of this statement by the Health Insurance Association of America is to urge the enactment of S. 736, relating to the employment status of individuals for tax purposes, introduced by Senator Robert Dole, and to oppose the Administration proposal to require that 10 percent be withheld from all payments for services to independent contractors in the course of a trade or business.

The Health Insurance Association of America represents over 300 insurance companies which write approximately 85% of the health insurance written by insurance companies in the United States.

S. 736 is an appropriate and workable solution to the problem of classifying workers as either employees or as independent contractors for Federal tax purposes. As introduced by Senator Dole, the bill sets forth five requirements which, if satisfied, would result in a worker clearly being classified as an independent contractor rather than as an employee. Those five requirements are:

1. The individual must control the number and scheduling of hours worked.
2. The individual must not have a principal place of business or, if having one, it cannot be provided by the person for whom the service is performed unless reasonable rent is paid.
3. The individual must either have a substantial investment in the assets used in connection with the services performed or must risk significant income fluctuation.
4. The individual must perform the services pursuant to a

written contract that spells out his status as an independent contractor and the tax obligations associated therewith.

5. The person for whom the individual performs services must file all information returns required with respect to those services.

The requirements set forth in S. 736 are appropriate. The tests are clear, understandable, and can easily be applied. They can provide the certainty and uniformity which is vital if our tax laws are to be effective.

The bill should, however, be clarified in one respect. The bill is designed to provide a "safe harbor" test, i.e., if an individual satisfies all five requirements in the bill, he will definitely be treated as an independent contractor for tax purposes. There should be no room for inferring, however, that if all tests are not met an individual should automatically be classified as an employee. A provision should be added to make it clear that if any of the "safe harbor" standards are not met, determination of employment status will be made under the common law rules, as if the "safe harbor" criteria had not been enacted.

The Administration proposes to resolve the question of classifying an individual as either an employee or independent contractor by requiring that a flat 10 percent be withheld from payments made in the course of a trade or business for services provided by independent contractors. The

existing imprecise tests would be retained for determining whether the persons performing the services are independent contractors.

Enactment of such a proposal would not solve the classification problem. The classification of a worker would still be important if for no other reason than to determine which withholding system to use, i.e., the Administration's flat withholding percentage or the graduated withholding system for employees. Furthermore, aside from the particular situation for insurance commissions, the Administration's proposal presents severe administrative problems. The proposal, if adopted, will require payors, in even the most casual transactions, to either be the collecting agent for the government, often resulting in overwithholding, or to process massive amounts of paper to establish that withholding is not required. It is simply not appropriate to place these burdens on payors and payees.

In summary, unless Congress enacts substantive legislation setting forth appropriate and clear tests to be used in classifying individuals as employees or independent contractors, all the uncertainties and controversies involved in recent employment tax audits will reappear as soon as the interim relief enacted by Congress in the Revenue Act of 1978 expires. This will be true whether or not the Administration's proposed withholding system is enacted. The Health Insurance Association of America therefore urges immediate enactment of S. 736 and opposes the Administration's proposal for withholding on payments to independent contractors.

FEDERATION OF APPAREL MANUFACTURERS
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EXECUTIVE COMMITTEE

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Vice President, Co-Secretary

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Vice President

[illegible]
Infants' & Children's Coat Association, Inc.
Vice President, Co-Treasurer

October 17, 1979

Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Committee on Finance
U. S. Senate
Washington, D.C.

Dear Mr. Chairman:

In response to your press release dated September 10, 1977, soliciting written statements on S.736, the following comments are hereby submitted by the Federation of Apparel Manufacturers (FAM) on behalf of more than 5,500 United States Manufacturers of women's and children's apparel.

New York's women's and children's apparel manufacturers collectively comprise New York City's and New York State's largest industry. The manufacturers employ almost 170,000 workers in New York City alone. Most of these workers are women and members of minorities with insufficient skills to find new jobs if lack of profit drives their employers out of business.

The 5,500 women's and children's apparel manufacturers represented by FAM account for about 75 percent of the nation's production of this merchandise category. It is easy to understand, therefore, that the industry is one of the principal -- perhaps even the principal -- mainstay of the New York City and New York State economy. Yet, the vast majority of the manufacturers, perhaps 95 percent or more, are very small. A manufacturer with $2 million in sales is considered "big." Sales for most are in the $1 million or under range. For this reason, few manufacturers can afford to put full-time salesmen on the payroll. They are compelled to sell their merchandise through commission apparel salesmen recognized under existing law as independent contractors.

...more...

Industry net profits are dismal, ranging from 0.5 percent (or less) to 1.5 percent, according to Dunn & Bradstreet. The current combination of recession and inflation and the deep tariff slashes on imported apparel recently voted by Congress will, without question, further erode the already slim profitability in this troubled industry.

If the independent contractor status of the apparel salesmen were terminated or in other ways altered, it would immediately add new taxes to already overburdened apparel manufacturers and cause many firms to go under. It is therefore extremely important that the current status of apparel salesmen as independent contractors not be modified or threatened by any action taken by Congress.

The Internal Revenue Code already includes, in Section 3121 (d)(3)(D), (adopted over 20 years ago) a provision which classifies certain traveling salesmen as employees for Social Security purposes. Other cases are currently determined under the common law test. Under this test, as interpreted in Treasury Regulations and IRS Rulings, commission apparel salesmen have been classified as independent contractors. It is essential that Congress should not adopt any narrow special interest amendment which would change Section 3121 (d)(3)(D) or modify the common law test under which apparel salesmen have traditionally been treated as independent contractors.

S.736, sponsored by Senators Dole, Deconcini, and Matsunaga, would amend the Internal Revenue Code to clarify the standards used in determining whether individuals are not employees for purposes of employment taxes. This bill would add a helpful clarification to the common law test by providing a "safe harbor" test for independent contractor status. The bill would not have any effect on Section 3121 (d)(3)(D). The clarification proposed by S.736 would aid the apparel industry because it would insure the continued use of existing legal standards by the IRS and would prevent any future agressive interpretation of the common law test designed to undermine or change the rules which have long been followed in the apparel industry.

FAM and its 5,500 affiliated manufacturers strongly support S.736 and oppose any changes which would make the safe harbor test of that bill inapplicable to apparel salesmen or which would change existing law so as to reclassify apparel salesmen as employees.

Respectfully submitted,

Kurt Barnard
Executive Director

KB:rml
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