S. HRG. 103–998

CLASSIFYING WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS UNDER HEALTH CARE REFORM

HEARING

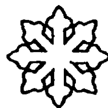
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MAY 3, 1994



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CLASSIFYING WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS UNDER HEALTH CARE REFORM

TUESDAY, MAY 3, 1994

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Bradley, Rockefeller, Daschle, Conrad, Dole, Roth, Chafee, Grassley, and Hatch.

[The press release announcing the hearing follows:]

[Press Release No. H-30, April 29, 1994]

FINANCE COMMITTEE SETS HEARING ON CLASSIFICATION OF WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS UNDER HEALTH REFORM

WASHINGTON, DC.—Senator Daniel Patrick Moynihan (D-NY), Chairman of the Senate Committee on Finance, announced today that the Committee will continue its examination of health care issues with a hearing on the classification of workers as employees or independent contractors, and the self-employment tax treatment of partners and S corporation shareholders.

The hearing will begin at *10:00 A.M. on Tuesday, May 3, 1994* in room SD-215 of the Dirksen Senate Office Building.

"Rules determining the classification of workers will be extremely important in extending health coverage to more Americans," Senator Moynihan said in announcing the hearing. "The Committee will explore this issue, as well as the related issues of self-employment tax treatment of partners and S corporation shareholders."

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. A very good morning to our distinguished witnesses and our welcome guests. Senator Packwood is somewhat delayed and asks that we proceed on schedule, as we try to do.

This hearing will focus on the curiously complex subject—at least I find it complex—which is the classification of workers as employees or independent contractors for purposes of our health care legislation, the various bills that we have.

The distinction between employees and independent contractors is important under current law in any event. But all the health care reform proposals under consideration by the committee would place additional consequences on proper classification.

For example, the requirement under the administration's legislation that employers contribute 80 percent of health care premiums applies only with respect to employees; and in addition the amount

applies only with respect to employees; and in addition the amount of subsidies provided to an employer depends on the number of employees working for the firm and their average wage. Independent contractors are not considered in this regard.

President Clinton's health care reform measure would modify the rules now used to determine classification. The proposal would modify the current provisions of Section 530 of the Revenue Act of 1978 and would give Treasury authority to promulgate guidelines that precisely—or we would hope precisely—define when a worker must be classified as an employee.

The committee is aware that many firms and self—employed individuals are wary of this approach and would prefer the clarity that now resides in Section 530. So we have to consider carefully how to proceed.

We are going to hear from a number of distinguished witnesses who will give us their views on the difficulties associated with worker classification and the administration's proposed solution. We would hope that those who oppose the administration's proposal will suggest alternative approaches to make this area of law more administrable and fair.

As would be appropriate, our first witness is Hon. Leslie B. Samuels, Assistant Secretary for Tax Policy of the Department of the Treasury, accompanied by Mr. Sam Sessions, the Deputy Assistant Secretary for Tax Policy, who, intrigued by the prospects of either marrow or financial reward, or both, has decided to leave the tax law entirely and become a doctor. That is the first positive of the administration's health care reform measures.

Mr. Secretary, you are well and, of course, hugely and favorably known to this committee as our sometime tax counsel. You serve with distinction as the Secretary for Tax Policy and we wish you well in the Goucher College Pre-Med Program. I think that takes courage as well as style. You are an example to us all.

But you will have to recuse yourself from any remarks today that might affect the future status of physicians. [Laughter.]

Mr. Secretary, we welcome you, sir. Would you proceed just as you wish.

Mr. Sessions. If I could just say, Mr. Chairman, thank you very much for those kind remarks and you are right in having identified at least part of my motivation for this decision.

The other part though is after having worked for the Finance Committee and the Treasury for 7 years I felt that I would pursue a more leisurely profession in medicine. [Laughter.]

The CHAIRMAN. Well said.

Mr. Samuels?

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC, ACCOMPANIED BY SAMUEL SESSIONS, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY

Secretary SAMUELS. Mr. Chairman, I am pleased to present the views of the administration on certain tax provisions in the Health Security Act. I would like to ask that my written statement be placed in the record.

The CHAIRMAN. Without objection, it will so be.

[The prepared statement of Secretary Samuels appears in the appendix.]

Secretary SAMUELS. I will limit my oral statement today to two sets of provisions in the Act that are the subject of today's hearing—those provisions relating to workers' employment status and a provision modifying the self-employment tax treatment of certain S Corporation shareholders and limited partners.

A fundamental feature of the Health Security Act is universal coverage. To accomplish universal coverage with the least disruption, the Act builds on the current system in which 9 out of 10 Americans with private health insurance obtain it through their employers. Thus, just as a large number of employers do today, they will pay most of the insurance premiums for their employees under the Act. However, the Act generally limits each employer's obligation to 7.9 percent of its payroll, which is reduced for small firms to as little as 3.5 percent of payroll.

A firm is obligated to provide health insurance only for its employees. To the extent a firm contracts for services from an individual independent contractor, the firm has no obligation to provide that individual's health insurance. It therefore is critical that workers be properly classified as employees or independent contractors.

The existing employment tax rules provide a definition of employee based on the traditional common law test which applies to virtually all firms. These rules are clear for the vast majority of firms and workers. Accordingly, we decided not to create a new definition of employee solely for health care purposes, since that would unduly burden employers with a second set of rules. Rather, the Act generally adopts the existing employment tax rules to determine the status of workers for health care premium purposes. The Act modifies the current rules, on a prospective basis, in two respects to prevent abuses in the health care system through misclassification of workers.

The first change relates to the definition of employee. To prevent employers from gaming the existing rules, the Act would authorize the Secretary of the Treasury to issue prospective regulations for determining the classification of workers whose status is determined currently under the common law test.

Let me emphasize that, as Secretary Bentsen has testified, these regulations are not expected to result in substantial reclassification of workers from their status under current law.

First, the prospective regulations would not override those Code provisions that provide mandatory classification rules for various classes of workers, such as real estate agents and direct sellers.

Second, to address the concerns that the regulations could disrupt existing worker classifications, the statute requires that the regulations give significant weight to the traditional common law test of current law.

The CHAIRMAN. Mr. Secretary, help a non-lawyer. The traditional common law test is what?

Secretary SAMUELS. It is a 20-factor test as announced by the Internal Revenue Service in a revenue ruling. We look at 20 factors which includes control over the worker, who purchases the equipment, the workers' duties. So it is a 20-factor test that depends on

the facts and circumstances of each particular relationship between workers and the employers.

The CHAIRMAN. Mr. Gale has just handed it to me. This is the 20 rules that synthesize what has been court rulings over the years that come to be considered common law?

Secretary SAMUELS. Correct.

The CHAIRMAN. Work for one employer at a time; do not offer their services to the general public; can be fired by the employer; may quit work at any time without incurring liability. Things like that. I got you.

Secretary SAMUELS. Third, we welcome guidance, for example, in the legislative history, regarding parameters for prospective regulations. In this regard we believe that the regulatory authority provides desirable flexibility in an area that is as complex and dynamic as the work place. A one-size-fits-all statutory rule cannot easily be adapted to changing work environments.

Fourth, the IRS as part of its Compliance 2000 initiative currently is working with several industries that have had particular difficulty with worker classification issues to develop guidelines for determining the status of workers in those industries. We anticipate that this work can serve as a useful model for developing the regulations.

Fifth, we are committed to work extensively and openly with interested taxpayers and industry representatives to develop appropriate guidelines.

Finally, the regulations will be effective no earlier than for periods beginning 6 months after the regulations are issued in final form. At the time that the regulations are finalized, the Secretary will provide a report to Congress regarding the regulations.

In summary, these prospective regulations will not cause a sea change in worker classifications, but will be developed to prevent gaming of the system.

The Act also addresses the special rules adopted in Section 530 of the Revenue Act of 1978. While Section 530 was enacted as a 1-year stopgap measure until Congress could devise a better standard for classifying workers, it was extended indefinitely in 1982.

Section 530 prohibits the Internal Revenue Service on audit from correcting erroneous classifications of workers as long as the employer is consistent in its treatment of the workers and has a reasonable basis for that treatment. Section 530 also prohibits the Internal Revenue Service from issuing any regulations or revenue rulings regarding the proper classification of workers.

In the context of health care reform, Section 530 in its current form could foster manipulation and abuse of both the requirement that employers pay a portion of their employees' health insurance premiums and the payroll-based premium discount rules.

Accordingly, the Act revises Section 530 prospectively to prevent these abuses, but in a manner that will provide reasonable protection to employers. Beginning in 1996 Section 530's protective rules would be extended to all firms. To avoid potential whipsaw situations, the determination of a worker's status under Section 530 would be controlling for both the firm and the worker. In addition, the 15-year-old prohibition on IRS guidance would be lifted.

The IRS would be permitted to correct the status of misclassified employees only on a prospective basis. As under current law, the employer would be protected from retroactive reclassification if the employer satisfies one or more safe harbors.

These safe harbors would be modified in certain respects to prevent possible abuse. For example, the prior audit safe harbor would be limited to tax audits in which the status of the worker or similar workers was actually reviewed without change. An audit in which worker status was not considered would no longer provide a safe harbor. Indeed, it is remarkable that such a tax audit safe harbor exists. The current rule that provides future amnesty for a position because a taxpayer was audited for a totally unrelated issue would be inconceivable in any other context.

The Act also increases the penalty for failure to file an information return for payments made to an independent contractor for services.

For purposes of computing an independent contractor's eligibility for income based premium discounts, the Act treats a self-employed individual as his or her own employee and treats his or her earnings as wages. In general, the individual's income tax return will provide the earnings information. It is therefore essential that a worker who performs services as an independent contractor properly report all of his or her income for tax purposes.

To prevent abuse of the premium discount rules, the Act increases the penalty for failure to file an information return for payments made to an independent contractor for services from $50 per failure to the greater of $50 and 5 percent of the amount not properly reported.

To ensure that the penalty will not be excessive and that it will not be imposed in instances of minor failure, the provisions of current law will continue to apply.

In addition, the Act limits the penalty to $50 per failure as under current law, if the taxpayer properly reports at least 97 percent of all such amounts required to be reported for the relevant period.

As you can see, we have carefully targeted this increase in the reporting penalty to give a stronger incentive to firms to report payments made to non—employees for services rendered but with ample protection to ensure that firms will not be subject to disproportionately high penalties for relatively minor failures.

The Act also adopts anti-abuse measures relating to S Corporation shareholders and limited partners. To avoid gaming of the health care premium discount rules, we have proposed to modify the employment tax rules for both health care and employment tax purposes for these taxpayers.

Under the Act, all service-related earnings of 2 percent S Corporation shareholders who materially participate in the corporation's business would be treated as wages for purposes of determining the corporation's eligibility for premium discounts. A similar rule would treat any individual limited partner who materially participates in a partnership's activities in the same way as general partners are treated under current law.

These provisions should level the playing field among the different forms of doing business and should eliminate any abuse of

the premium discount rules through changes in the form of business entities or compensation arrangments.

Mr. Chairman, I appreciate the opportunity to appear before this committee today to discuss these important tax provisions. We look forward to working with this committee and interested taxpayers to develop fair and effective rules. I will be pleased to answer any questions that you or other members may wish to ask.

The CHAIRMAN. Let us see if we can first of all before we get to questions we have a number of Senators who have joined us and they might want to make opening statements.

Senator Conrad?

Senator CONRAD. No, I withhold any opening statement.

The CHAIRMAN. I wanted to report to all of you that our good friend Sam Sessions down there is leaving the Treasury. He is going to go to medical school.

Senator Chafee?

Senator CHAFEE. No statement, Mr. Chairman, except to point out that there are intricate problems raised by the administration's approach to this, as Mr. Samuels has pointed out—who is an independent contractor; who is an employee. All those problems focus more under this situation under the administration's bill.

Under our bill I would point out that these problems do not arise because in the final analysis you look to the employee for the responsibility of the health care coverage. The individual, I should not say the employee—the employee/independent contractor.

So whether he or she is an independent contractor or an employee does not come into play because the individual is responsible in the final analysis for his or her insurance.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hatch?

Senator HATCH. Mr. Chairman, thank you. I will just put my statement in the record and appreciate listening to our witnesses this morning.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Well, that is the question. Mr. Secretary, when you say gaming the system I assume what you refer to, your concern about it, is that under the President's proposal employers have to provide health insurance for employees and there might be a disposition to assert that someone is not, in fact, an employee, but is an independent contractor.

The number of employees determines the rate, the amount of premium, that employers are required to pay. Again, the fewer employees acknowledged the lower the premium. So that is your concern.

Secretary SAMUELS. That is correct.

The CHAIRMAN. Do you propose that this be done in a regulatory mode rather than a statutory position?

Secretary SAMUELS. Yes, sir. We have looked at this issue and we think that the relationships between employers and their workers is so complex that it would be very difficult to draft statutory language that we have characterized as "one size fits all."

The CHAIRMAN. And more difficult to change it if it turns out it is not working well enough.

I do not know if I can ask the committee, it appears to me that what we ought to do is wait until we get a better idea of what our legislation is going to look like and then sit down with you. Do you not think we will need to sit down with you and go over this subject in terms of what we finally produce?

Senator CHAFEE. I think so, Mr. Chairman. It is incredibly complicated and they have that Section 530 that I take it would be repealed under this and then would be done by regulation. Am I correct in that, Mr. Samuels?

Secretary SAMUELS. Senator Chafee, our proposal is to modify Section 530 so that in modified form it would apply until regulations were finally promulgated. We think it would take some time to write regulations that would apply on a prospective basis.

The CHAIRMAN. What do you mean by some time, a year?

Secretary SAMUELS. I would have thought at least a year.

The CHAIRMAN. At least a year.

Secretary SAMUELS. I would think probably 2 years.

The CHAIRMAN. Yes.

Senator CHAFEE. It is a murky field, as you know, Mr. Chairman. We have wrestled with this before. I think your suggestion is a good one.

Secretary SAMUELS. Mr. Chairman, if I might mention——

The CHAIRMAN. Please.

Secretary SAMUELS.—this issue of who is an employee and who is an independent contractor obviously comes up in the way the President's plan is designed. But I would just note that in any plan that you consider, where there is a distinction based on employment, you have to deal with this question.

For example, if subsidies or premium discounts are in a plan which depends on the size of a business, you have to deal with this issue. And if you have a situation—for example, Senator Chafee's plan—of an individual mandate, to the extent that you do not want to disrupt the current patterns where employers provide health insurance for their employees, and so you decide that in order to avoid the disruption you would want to have a maintenance-of-effort provision, which raises separate issues. But in this context you want to have maintenance of effort to try to avoid disrupting the way a lot of individuals receive their health insurance.

Or you might put in nondiscrimination clauses so that if an employer who is now providing health insurance cannot discriminate against classes of employees under even an individual mandate; that might be a possibility.

In those circumstances, one has to face this issue. It comes with the design of a health care reform system in a lot of different contexts. So I think you are correct, this is an issue that you have to look at as you go through the process and it is just not a question that is associated with the administration's proposal.

The CHAIRMAN. Clearly. I know that it is certainly this Senator's view that we would hope to devise a system that has as few consequences in terms of economic organization as is possible. We are concerned with health care and not business size or firm/organization and things like that. Without intending it, we could wander into some large unintended consequences here.

So we expect you to keep close watch on what we do. Is Secretary Sessions going to disappear before all this?

Secretary SAMUELS. I believe his course starts mid-June. So he is going to escape.

Mr. Sessions. Well, I would have had to recuse myself from health care related issues anyway. So I thought it would be better to go ahead and get started early.

If I could just say also, it was an enormous privilege to serve as a member of the staff of this committee and those are memories that I hold very fondly and it was a great professional and personal experience for me.

The CHAIRMAN. Well, we thank you, sir. You know it is reciprocated. If we ever need a doctor, a doctor who understands the Tax Code——[Laughter.]

What a terrifying idea.

Senator Conrad?

Senator CONRAD. It is a comforting thought, Mr. Chairman—a doctor that understands the Tax Code.

As a former Tax Commissioner, I may actually be somebody that will come to you for treatment. I am wondering, Mr. Samuels, how many independent contractors do we have in the country? Do we know that?

Secretary SAMUELS. I do not have that specific number.

Senator CONRAD. Do you have any idea of how many, what percentage of those would be reclassified?

Secretary SAMUELS. Our view is that the regulations would not result in the reclassification of the vast majority of employment relationships. We are really worried about people gaming the system by reorganizing themselves or having employees switch to independent contractor status.

So we are not trying to rewrite the rules that now apply to a vast majority of employment relationships.

Senator CONRAD. So when the real estate people come in and express concern that their current categorization might be altered, your response would be?

Secretary SAMUELS. Our proposal, for example, does not affect the statutory rules that apply to certain categories of workers like real estate agents and direct sellers. Our proposal does not change any of those rules.

Senator CONRAD. So there would be no change with respect to the status that they currently have?

Secretary SAMUELS. Correct. Those relationships that are covered by statutory provisions would not be changed under the administration's proposal.

Senator CONRAD. Do you have any idea how much the IRS currently estimates that self-employed are underpaying their taxes by?

Secretary SAMUELS. I do not have those numbers segmented that way. But there have been some studies done by the IRS on compliance rates.

Senator CONRAD. Do you have compliance figures for——

Secretary SAMUELS. I think this goes to our proposal to increase the penalty on the filing of Form 1099s which report payments to independent contractors. The statistics that we have are that when 1099s are actually filed and the amounts are reported for independ-

ent contractors, there is a 97 percent compliance rate. When they are not reported the compliance rate drops to 83 percent.

With respect to those taxpayers that are determined to have misclassified themselves as independent contractors, the compliance rate drops further. For that group the statistics are that 77 percent comply when 1099s are filed. And for those workers who misclassify themselves when the 1099s are not filed, the compliance rate drops to 28 percent.

Senator CONRAD. So we have a substantial compliance problem now. I am told that the number in terms of underpayment of taxes for self-employed is something over $20 billion. It would seem to me that the health care plan that we have before us would certainly encourage people to move in the direction of self-employed for obvious reasons.

Certainly employers would have a tremendous incentive to reclassify people. What I hear you saying is that the increased penalty for the filing of information returns is what is hopefully going to prevent that or diminish that possibility. Is that correct?

Secretary SAMUELS. That is correct, Senator.

Senator CONRAD. How much confidence do you have that this will be an effective method?

Secretary SAMUELS. I think we have found that when information reports are filed the compliance rates are higher, significantly higher. So I think that is an important feature of our voluntary compliance system now and we think it should be continued.

Senator CONRAD. If people do a cost benefit analysis of what they save versus what the risk is in terms of failure to file information returns, is it not going to be a substantial incentive not to file? Is there not going to be an awful lot to gain for them if they measure what it will save them in outlays versus what it will cost them if they get caught for failure to file an information return?

Secretary SAMUELS. Well, the penalty provisions that we are proposing for failure to file Form 1099s is to increase the penalty from the current rate of $50 per information return to $50 or 5 percent of the underreported amount.

We think that that is a substantial change and would encourage people to comply. Obviously, there is a balance between penalties that are reasonable and ones that can be enforced.

Then if there is a willful failure to file the return, the amount is increased to 10 percent of the tax of the underreported amounts, and the caps that exist under current law, the total amount that can be imposed as a penalty, are lifted.

So for those who intentionally want to disregard the rules, I think the penalties are quite significant.

Senator CONRAD. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Conrad.

Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

Gentlemen, I am really deeply concerned about the cumulative effect of the various proposals of this administration on small business. I say I am concerned because if you go back to 1988 and through 1990 it was small business that created jobs, something like 4.1 million when big business, I think, reduced by 500,000.

Nevertheless, Congress increased—the administration increased—taxes on small business from 31 percent to 42.5 percent or even higher. That is a huge increase. Then we have the health plan, and in the health plan it has been estimated that with the mandate on all employers that something like 850,000 individuals will lose their jobs.

In the case of Delaware it is something like 2,600. Frankly, that is a large number for a small State, as I am sure you appreciate.

Now we want to transform income from small business so it is treated solely as income from labor. You know that is not necessarily true. And, in fact, you are proposing to raise taxes by 3 percent.

My question is: Are you not concerned about what this is going to do to small business, the growth portion of our economy that is so important for creating jobs?

Secretary SAMUELS. Senator Roth, we have carefully considered the consequences of the health care reform proposals on small business. That is the reason that the administration's proposal has special discount rules that are available to small business owners.

We think that those rules are appropriate and will help a small business that now does not provide health insurance. And for those small businesses who are now paying health insurance for their employees—and as you know there are a lot of small businesses that are paying health insurance for their employees—the premium discounts will help them because those are the types of companies that are being particularly hurt by the very high premiums that are now being charged.

It is the small business that has the problem of obtaining health insurance at a reasonable price. So we think when you look at our plan you will see with the subsidies provided and the cost containments that the effect will be quite positive for small business.

Senator ROTH. Well, the National Federation of Independent Business, of course, does not agree. They estimate that it is going to cost something like 850,000 jobs, which is a lot of jobs.

It is desirable for everybody to have health insurance, but not at the cost of their jobs. What bothers me now is you go to this proposal today and again you are going to, in effect, impose a higher tax on small business.

Small business already is paying much higher taxes. The S Corporation is as high as 42.5 percent. Whereas, big business is paying, what, 35 percent. I am just concerned about what we are doing to that part of our economy that is critically important to our growth in the creation of new jobs.

I just wonder, have you made a study to look at what the cumulative impact is going to be of these proposals?

Secretary SAMUELS. Senator Roth, I might comment that the current tax rate structure of the higher marginal rates for individuals, higher than for corporations, is the traditional pattern that has existed really since the beginning of the Tax Code.

If you look back to the 1950's and 1960's and 1970's, the individual marginal tax rate was well above what it is today and well above what corporations——

Senator ROTH. Are you arguing——

Secretary SAMUELS. So I am just saying that we are now in a condition where we were before when our economy was thriving and small business was thriving and that tax rate structure——

Senator ROTH. You are justifying even higher rates? Is that what you are saying?

Secretary SAMUELS. No, sir. I am saying if you look back in time into the 1950's and 1960's and 1970's, the individual tax rates, marginal tax rates, those highest rates, were significantly higher than they are today. That was a period when our economy and small business was doing extremely well.

Senator ROTH. Well, Mr. Chairman, all I can say is I do not believe higher taxes are the way to go. I still believe reduced taxes will create growth and revenue for the government.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth, I have been on this committee 18 years with you. You have been consistent in that position. I do not think I have ever heard you say otherwise.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman. I do not have any questions. I guess I would just respond to our colleague Senator Roth.

There are many advocacy groups out there making a lot of assertions about jobs. I think that, if one looks at the five reputable studies that have been done so far, there is an interesting consistency among all of the studies, both in the public and the private sector.

The Congressional Budget Office has said that the effect on jobs of the health reform plan would be negligible. The National Employee Benefits Research Institute, a very reputable organization, actually maintains that there could be a creation of jobs—660,000 is the figure they use.

But there are five studies that have been published in and out of government that all claim I think with some authority that the effect on jobs would be negligible.

We have heard the same job loss claims by the NFIB every time we have considered a minimum wage increase. A couple of years ago there was a substantial outcry from leadership in the NFIB about the implications of a minimum wage increase for jobs. We increased the minimum wage, and job growth among small business concerns actually increased dramatically over the last several years, as the Senator pointed out.

The health care increase in premium for small businesses at a discounted rate represents 15 cents an hour for a minimum wage worker, which is one-third the cost of the most recent minimum wage increase. So clearly, if the minimum wage increase was implemented with negligible, in fact, positive job growth, then I would think the studies that have been done are accurate with respect to a 15-cent increase.

Finally, I would just say, there are those who have proposed that we just allow small business voluntarily to participate in insurance with no discount. I guess my question is: If they are not likely to participate with a 3.5 percent premium, what will small business

who are not providing insurance today do if that premium is 10 or 11 percent? What kind of participation will we get then?

My guess is that we will not get much participation. So I fear that without some kind of ability to provide discounted premiums through some form of shared responsibility with employers and employees we are not going to get the kind of participation we want; and ultimately, a lot of small businesses are going to be faced with the same choice that my small businesses are faced with today. That is, paying increased premiums or letting some of their part-time employees go.

That is all too often what happens. I would hope we could avoid that and set as our goal that it should not be a choice between increased premiums and jobs in the future.

I thank Mr. Samuels for his testimony and appreciate very much having the time to respond.

The CHAIRMAN. Thank you, Senator Daschle.

Senator Grassley?

Senator GRASSLEY. Mr. Chairman, I had a statement I was going to give. I want to put that in the record.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator GRASSLEY. It expresses my concern about the process by which we would have the Treasury Department define what an employee is. I guess that is based upon my feeling that over the last 14 years that I have been on this committee we had a hard time arriving at safe harbors so that people would know when they were an independent contractor and when they were not.

So I am glad to hear that you are advocating sitting down and reviewing this proposal. I want to say to you I appreciate that. I would hope in your reviewing the proposal that if we are going to let the Treasury Department define what an independent contractor is, that we at least would know what that definition is before we vote on it.

The CHAIRMAN. If I could just say without interrupting, I think Secretary Samuels has been very forthcoming in that respect.

Senator GRASSLEY. So there would not be any problem then if we were to go this direction that when we were voting on that issue we would know exactly what they had in mind?

The CHAIRMAN. To the extent that they know their minds. The Secretary suggested that it may take 2 years to produce a final regulation. But I think we will have their cooperation.

Senator GRASSLEY. You know, there are hundreds of regulations that we pass law for that have not been written yet. It seems to me like what we are doing is just avoiding our own responsibilities as legislators, the extent to which we turn over to somebody else to write regulations when all the regulations have not been written for laws that have been passed eons ago.

Well, I will go to my question now after expressing my concern. Secretary Samuels, I agree with Senator Roth that your independent contractor proposal is going to have a big impact on small business. Not only will the proposal have employment tax and income tax consequences, I think it will also conceivably impact wage and pension responsibilities.

I wonder, have you had a chance to study or estimate these added costs to businesses that are trying to create jobs and improve the economy?

Secretary SAMUELS. Senator Grassley, our proposal is not meant to result in a major shift in the classification of workers. In fact, we think that the proposed regulations would not result in the reclassification of but a few potentially.

We are looking at situations where employers would attempt to abuse the system by shifting employees to independent contractor status in order to take advantage of the discounts that are available in premiums and also to avoid an employer's obligation to pay for part of an employee's health insurance.

So we look at this as an anti-abuse rule and we have taken what we think to be significant steps in trying to define the scope of our authority. For example, we are not asking that any of the existing statutory rules on classification be changed. The statute also requires that the regulations give substantial weight to existing common law.

We, as I have said in my testimony, look to you for additional guidance. We would expect that there be guidance in the legislative history on how we should draft our regulations. And finally, the regulations will not come into effect until 6 months after they are published in final form and a report by the Secretary of the Treasury is delivered to Congress.

So we have tried to build in safeguards along the way so that we have an open process where all interested parties can give their comments to us, with the result that we do not believe, as I said at the outset, that there will be a sea change in classification.

Senator GRASSLEY. At this point then we are venturing down this road without functioning under any estimated costs of businesses and you are assuming that there is no impact on business.

Secretary SAMUELS. That is correct. Only those businesses that are trying to avoid their obligation in some way will be the target of this proposal.

Senator GRASSLEY. Well, I hope you do not blame me for having a healthy skepticism about that because there is very little that the Congress does not do in tax policy that does not change a lot of practices.

We assume a stagnant—not stagnant, but a kind of a steady estimate of what revenue is going to be without the economic consequences of our changes. Yet we find out later on that there are economic changes that do change people's behavior and the marketplace changes. Consequently, it changes estimates of the cost of business as well as the income that comes into the Treasury.

Thank you.

The CHAIRMAN. I think that is entirely fairly stated. I mean, you never change just one thing. The world is a dynamic place.

Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

Mr. Samuels, there are a lot of people that I have heard from that are very concerned about the change because they are afraid that it is going to create chaos.

What I wondered is, what words can you offer to assure them that if you get this kind of authority you are not going to be in a chaotic situation.

Secretary SAMUELS. Senator Bradley, I would make a couple of comments. First, we have made a significant effort already to meet with interested groups to discuss this proposal. I think by last count we have met at the Treasury with over 20 groups from both business and labor to discuss this proposal. So we are already trying to get input in the process.

In addition, as I said, we have the regulation writing process which is an open process and we have a delay in the effective date of the regulations to be 6 months after the regulations are adopted in final form.

In addition, the statutory language requires us to give substantial weight to existing common law. So we know that this is an issue that some are concerned about, and we have tried to build into the process and into the statutory language assurances for people that this process is going to be conducted in a responsible manner.

We look forward to legislative history that further gives us guidance on what should be in the regulations. We have also said that if interested groups or the members of the committee have statutory language that they think we should consider, we would be happy to consider that.

I think we have to try to think about what kind of statutory language we could draft. We think that this is too complex of an area to have one rule apply to everyone. So we think regulations which can be drafted to deal with different industries is the best way to deal with this area and to prevent abuses from developing in the health care reform system.

Senator BRADLEY. Thank you.

The issue of tax exempt institutions—we had a hearing the other day and a number of issues came up. I wondered if you could explain the line that Treasury drew in defining which HMOs would be tax exempt and which ones would not.

Secretary SAMUELS. Senator Bradley, this is a difficult area, deciding where to draw the line. At one end you have the traditional hospitals that have always been tax exempt and should continue to be tax exempt; at the other side of the spectrum you have the traditional property/casualty companies that are writing fee-for-service indemnity insurance. Those are the two extremes.

For HMOs that are organized on the so-called staff model, so that the HMO actually employs the doctors and other health care professionals, and may own the facilities, we think that the HMO should be classified like a hospital and be tax exempt, as it is under current law.

With respect to non-staff model HMOs, we think that the dividing line—which is very much like current law—should be whether the HMO has a pre-existing contractual relationship with the providers and whether it pays its primary care physicians on a fixed or capitated basis, thereby shifting the risk to the providers. In these cases, an HMO should be tax exempt because it is participating in the health care system as more than an insurer.

I might add that if you look at the HMO market, an interesting development has occurred. Taxable HMOs have increased over the years. At the present, the taxable HMOs are more than half of the market. So they have taken over at the expense of the tax-exempt HMOs.

We think there is a place for tax-exempt HMOs as well as tax-exempt hospitals, and that having a tax-exempt part of the health care industry is important. They have something important to contribute.

Senator BRADLEY. Right.

Secretary SAMUELS. That is how we have drawn the line.

Senator BRADLEY. How can we be sure that a tax-exempt HMO is actually providing a community benefit at least sufficient to cover its tax subsidy?

Then also, could you tell me, it used to be before 1969 that to get a tax exempt status for a hospital you had to provide charity care, would you support a provision that would require a certain amount of charity care to be provided by a tax exempt hospital in order to qualify for the various tax subsidies that flow through to tax-exempt institutions?

Secretary SAMUELS. Senator Bradley, we have looked at that question especially in light of health care reform. As you know, with universal coverage the requirements of charity care will change. If everyone has coverage, the demands on the hospitals for charity care will go down.

The CHAIRMAN. Not in Newark they will not.

Secretary SAMUELS. I say go down dramatically. I do not think they will be eliminated. There will still be those who for whatever reason are not in the system.

We think that when you look across the country and the differences among communities that it is very difficult to have one standard which will apply to everyone, i.e. X percent has to be for charity care.

What we have basically done is stick to the current law—the so-called community benefit test—and added to it a process requirement, so that the health care organizations are required on an annual basis to assess the needs of the community and to develop a plan to meet these needs, and this process is to be accomplished with the participation of the community.

We have given in our written testimony a fairly long example of how that process should be carried out.

Senator BRADLEY. Who in Treasury reviews these every year?

Secretary SAMUELS. I think when the IRS does audit tax exempt organizations and when they audit a hospital they would look to see whether the hospital has complied with these rules. I would say though that the hospital's Board of Directors who is ultimately responsible for running the hospital, and they know what these rules are, would have a burden on them to make sure that the rules, this process, takes place in a fair and appropriate way.

Senator BRADLEY. But do you admit that there is a potential problem in a world of health care reform that people will be attempting to shed the more costly and accept and promote the more profitable? And in terms of tax exempt it is not a contradiction. The more of those that generate revenue; charitable care is at least a

criteria that should be considered. Would you not agree? It is a little different circumstance.

Secretary SAMUELS. Senator Bradley, we agree that in light of health care reform the standard should change. We struggled with how to change the standard and this is what we have come up with. We would be happy to discuss if people have other ideas as to how to move the line. We do think the line needs to be moved.

Senator BRADLEY. Could I ask one more question?

The CHAIRMAN. Of course.

Senator BRADLEY. On another matter that is related to tax but not related to the independent contractor, the administration has a sizeable tobacco tax as a way of paying for some part of health care reform.

There are a number of us who think that one should not only discourage consumption by raising the price but also we should discourage consumption by removing the taxpayer subsidy through the promotion and advertising of tobacco consumption.

So I am curious in terms of removing the deductibility for the advertising of tobacco, if you had a thought about that. Because as I have said on any number of occasions on the committee it is worth about a billion dollars a year that goes essentially right from taxpayers into the pockets of the tobacco companies that use that money to essentially mail in the direct mail fashion to those young people when they reach the age of 16 in targeted areas these elaborate advertisements that have pictures of Joe Camel and offers of special shirts and benefits if they buy a certain number of packs of Joe Camel. In other words, getting people hooked on an addictive substance at age 16.

My question to you is: Would you support removing the deductibility for tobacco advertising?

Secretary SAMUELS. Senator Bradley, we share your concern about tobacco use by young people. This is a matter of very significant concern to the administration. I think that we have said at the beginning and we would say now that the purpose of our tobacco excise tax increase is not merely to raise revenue, but to serve a very important public health purpose of reducing consumption.

We think that our excise tax proposal will decrease consumption, especially among young smokers or young tobacco users who tend to be more price sensitive than others.

I think the statistics that we are aware of is that 80 percent of the adult smokers in the United States begin smoking, begin using tobacco products, before the age of 21. So we think it is very important to try to discourage the use of tobacco products. We think that the excise tax is the best way to do that.

With respect to the proposal to deny the deduction for advertising of tobacco products, I have a couple of comments. One, I think under general tax policy principles we think that with rare exception ordinary and necessary business deductions should be allowed in measuring income.

Senator BRADLEY. What are those exceptions?

Secretary SAMUELS. There are some special exceptions that we have. As you know, for example, we deny deductions for criminal penalties that are paid because they are criminal activity.

On the other hand, if somebody is engaged in a criminal business they are still entitled to their deductions for whatever would be their ordinary or necessary expenses.

The CHAIRMAN. That is a little complicated.

Secretary SAMUELS. That is the purpose of the tax law—to measure income ultimately. I think the other point is that when you compare disallowing advertising deductions for tobacco products with what we view as our more direct proposal, it is not at all clear to us that denying the deduction will directly affect the level of tobacco use by young people.

The tobacco companies could continue to advertise. They just would not get a deduction. It might mean that they earn less profits so that they absorb the cost. But when we weigh the considerations, we think that a direct approach, that is increasing the excise tax——

Senator BRADLEY. No, I am not talking about replacement. I am just trying to get your view. Are there any other exceptions that you are aware of?

Secretary SAMUELS. We have exceptions. For example, to the extent that an expense is viewed as personal they are not deductible. So, for example, the meals and entertainment expense has been——

Senator BRADLEY. So we do limit the meals and entertainment expense, do we not?

Secretary SAMUELS. Correct.

Senator BRADLEY. I think we do not allow full deductibility for meals and entertainment, do we?

Secretary SAMUELS. That is correct, because of the personal nature of the expenses.

Senator BRADLEY. How much do we allow as a deduction?

Secretary SAMUELS. At the moment it is 50 percent.

Senator BRADLEY. So that if we are arguing the threshold, we have already crossed the threshold in terms of limiting deductions. In terms of tax policy, what is the difference between a 50 percent limitation on meals and entertainment and an 80 percent elimination of tobacco advertising?

Secretary SAMUELS. In my mind it is the nature of the meals and entertainment expense that carries with it a kind of inherently personal aspect. Advertising that is conducted by a business is, I think, generally viewed by individuals as part of an ordinary and necessary business expense.

Senator BRADLEY. So the people who are deducting their meals, I mean, it is personal and not business? They are not saying to someone, how about this contract or what do you think about the deal or maybe even trying to interest someone in buying something from them?

Secretary SAMUELS. Well, I think there is obviously a whole range of motives that are associated with business meals.

Senator BRADLEY. Like maybe selling or you might even say advertising their product with a person that they are having lunch with, try to convince them to buy the product.

And we also limit executive compensation, do we not?

Secretary SAMUELS. That is correct.

Senator BRADLEY. So I mean that is a deduction we have limited, too, is it not?

Secretary SAMUELS. Correct.

Senator BRADLEY. So, you know, the argument that somehow or other we have never done this and we cannot do it for tobacco companies is I think we have crossed that threshold.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bradley.

Senator GRASSLEY. Mr. Chairman, could I have 60 seconds, please?

The CHAIRMAN. You can. Senator Conrad has a question.

Senator GRASSLEY. All right. He was here before I was. Let him go.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. I thank the Chairman. I thank my colleague from Iowa as well.

Mr. Samuels, the more I have looked at this the more I wonder if, with respect to S Corporations, the changes that are being proposed here are really more significant than we have discussed. The reason I think that is the case is because currently an S Corporation owner can take out part of what the corporation earns as wage income. He can take the rest out as dividends and not pay self-employment tax on that part that comes out as dividends.

As I understand it, the proposal that you are making here is that all income coming out would be treated as net income if a three-part test is met—the shareholder owns 2 percent or more; materially participates; and it is a service business. So that strikes me as quite a considerable change. And it assumes, does it not, that doctors, lawyers, and engineers that do business as an S Corporation basically have no investment in capital and all the income earned is wage income and none of it represents return on investment? Would that not be the case?

Secretary SAMUELS. Senator Conrad, our proposal, the purpose of our proposal, is to treat those S Corporation shareholders who meet those three criteria—a 2 percent shareholder; materially participate in the business; and a service-related business—that that category be treated exactly the same way as sole proprietors or general partners in a partnership.

So what we are trying to basically do is eliminate a loophole in a system that now exists to give S Corporation shareholders who meet these three criteria an advantage over those business people—small business people—who operate their business as sole proprietors or general partners.

The law from the beginning with respect to the self-employment tax has been that if you are a sole proprietor or a general partner you pay self-employment tax on your income—with some exceptions relating to interest, dividends, capital gains—and to the extent that those businesses have capital invested in them, and some of them do, the tax law has traditionally taxed all of the income from those types of businesses.

Senator CONRAD. I understand that. But I think if we are going to label this correctly, it is fairly stated that you are treating S Corporations that meet the three-part test the same as you are treating others who are constituted in a different way. But none-

theless this represents a significant change from current law, does it not?

Secretary SAMUELS. It represents a change in current law and it is our attempt to have the various pass-through entities, which are partnerships and S Corporations, treated the same way as sole proprietorships so that you will not have individuals who are now in sole proprietorships change to S Corporations in order to abuse the rules of the Health Security Act.

There was a recent article—I guess in the last year—in the Wall Street Journal pointing out this tax planning possibility. We think that if you do not have this type of provision you will have a significant shift so people can get higher premium discounts by not taking any salary out, for example, and that is something that we think would be inappropriate.

Senator CONRAD. I understand the objective and I understand it is well motivated in many ways. I also understand this represents for S Corporation owners a greater change than perhaps has been highlighted here. I say to you that in the case of a doctor, for example, that has a substantial investment in equipment, when you say all of the income coming out represents net self-employment business income, and that none of it represents a return on investment in that equipment, is that really fair?

Should there not be some acknowledgement that at least some of that income may represent return on investment? And is that not true of a lawyer that has got an investment in capital? Is that not true of an engineer that has invested capital? So that at least some part of that stream of income that is coming out fairly represents return on investment and should that not be represented in some way?

Secretary SAMUELS. Senator Conrad, we have thought about that question. I think that the problem, as is often the case in trying to draw lines, is that if you want to provide some kind of special rule for capital investment, it would be very difficult to administer. We have, I think, been fairly trying to minimize and slow down the development of complexity in the Internal Revenue Code, especially where it relates to small business.

This would, if you tried to write that kind of rule, I think, inevitably increase the complexity in a significant way.

The other thing that I would add is that like a lot of these rules, they cut both ways. Our proposal on S Corporation shareholders provides a favorable result to those S Corporation shareholders who meet the three criteria who have losses from their S Corporation; and there are a substantial number of S Corporations with losses.

So they will be able to offset those losses against, let us say, their salary from the S Corporation in calculating their eligibility for premium discount so that this actually represents a benefit for those S Corporation shareholders who meet the criteria and have losses.

So these things are always sometimes a little more complicated, but there is a class of people here, a significant class, who will benefit from this proposal.

Senator CONRAD. Well, let me just say that I think in fairness this does represent a significant change from current law with re-

spect to S Corporations that we ought to—if we are making a change here to close a loophole, we ought to do it with our eyes wide open.

I would say to you, I think in fairness some de minimis rule ought to apply here because the fact is some of that income coming out represents a return on a capital investment. It should not all be treated as net self-employement business income.

The CHAIRMAN. Thank you, Senator. I think Secretary Samuels has made clear he is open to any suggestions we have and he will be working with us very carefully as we put together our legislative history and what legislative language we decide on, if any.

Senator Grassley? Sixty seconds, as we have a very important panel.

Senator GRASSLEY. Mr. Samuels, would there be any reason why if we were to follow your suggestion that in writing the regulations that you could not just leave the existing safe harbors, assuming that your motive is to go after people who are cheating or people who in the future might find some reason because of health care reform to change their method of operations?

So that those people in businesses who have, we will say, operated for a few decades under existing law and presumably legally under that will not have their business relations or their way of operating upset because of what we might pass in a way of giving you permission to define employee and employer.

Secretary SAMUELS. Senator Grassley, the statutory language requires us in drafting regulations to give substantial weight to the existing common law. That is why we do not think and we do not intend that these regulations will cause any sea change in classification.

So that, therefore, there are businesses who have had long and well-established relationships for which there is no dispute. We do not see how those would be disrupted.

Senator GRASSLEY. Well, all right. I guess the answer then is the extent to which we, some of us, might suspect that that is a motive of changing some of those business relationships, the extent to which you convince us that that is not going to happen.

I think that you could change common law, even though the tradition has been not to do that once we do away with the existing statute. It seems to me if you are after tax cheats, then we ought to go after the tax cheats and we should not be doing something here that is going to upset something that for decades has been a legitimate way of doing business.

I mean there is nothing wrong with going after tax cheats. That is your obligation and my obligation. But why should we upset the way business has been done successfully in this country over a long period of time?

I suppose the reason for my question is that we just would foresee such huge costs to health care reform that the Treasury is going to do everything they can to bring in more revenue which eventually means that we are going to change the way that business has been done for a long period of time.

Secretary SAMUELS. Senator Grassley, as I have mentioned, we expect that the legislative history to this provision would give us guidance and that guidance, for example, could include references

to specific industries that have had longstanding, well-established relationships. We would, as I have said, look forward to working with the committee to develop guidance.

And in addition, if people have legislative language that they would like to discuss, we are happy to discuss that as well and review it.

Senator GRASSLEY. Would your administration be able to accomplish its goal if this committee let you define employer/employee within the context of something different and beyond the present safe harbors or would that make your job as you see it impossible?

Secretary SAMUELS. I think that there are some problems with what you would classify as the existing safe harbors. Section 530, which was adopted in 1978 as a one-year stop gap and has been extended indefinitely, in 1982, I think was drafted with the view that it was not going to be a permanent feature of the tax system.

There are some, I think, deficiencies of Section 530 that have now shown up over the years. I do not think they were really thought of as deficiencies when the Section was first enacted because no one thought that it was going to last this long.

We have in our legislation proposed some modifications of Section 530 until regulations are drafted and gone through the regulatory writing process. So we do not think, as our legislative proposal reflects, that just sticking to the Section 530 safe harbors as now drafted would be an appropriate way to proceed.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Dole?

Senator DOLE. No,I arrived late and I do not understand a thing. [Laughter.]

The CHAIRMAN. Senator, you are not in any way behind this curve. I assure you.

Secretary Samuels, you have been very forthcoming. These questions Senator Grassley raised and Senator Conrad raised are real. We will work together in this manner as you have suggested. I am sure in the end we will do as best as can be done. This is not simple.

One point Senator Bradley raised about the tax exemption of HMOs. You suggested the range. You made the point that probably the majority of HMOs are now taxable entities.

Last Thursday we had some very important testimony from Professor Fordom, who spoke of the modification of health care. It is happening right before us. In that sense it becomes more a province of the Treasury Department than it has perhaps in the past. So we welcome you to your rulemaking.

Mr. Sessions, great fortune to you in your new career. Sam is going off to be a doctor. If we do not see you again in this committee, we wish you the very best.

Mr. SESSIONS. Thank you very much.

The CHAIRMAN. Thank you, Mr. Secretary.

And now we have a panel of persons actively engaged with this question in one role or another. I see Patricia Bellows is up front, who is the Executive Vice President of H.D. Vest. I see Bruce Heiman is here as counsel. We welcome you, Mr. Heiman.

Robert Georgine, the President of the Building and Construction Trades Department of the AFL–CIO, who is well-known to this committee and welcomed back.

Professor Myron Hulen. Do I have that right, sir?

Mr. HULEN. Yes, sir.

The CHAIRMAN. He is a professor of accounting and taxation at Colorado State University. Robert J. Miranda, who is president of R.J. Miranda & Company on behalf of the Hispanic Business CEO Roundtable; and finally Mr. David Scherb, vice president of Compensation of PepsiCo Inc. in Purchase, NY. Mr. Scherb, again, good morning. We welcome any colleagues.

I think you in particular were interested in PepsiCo.

Senator DOLE. Right. We are happy they are here and happy Mr. Miranda is here.

The CHAIRMAN. We are happy you are all here. You have been very patient and so why do you not proceed. Ms. Bellows, you are first on the list.

STATEMENT OF PATRICIA A. BELLOWS, EXECUTIVE VICE PRESIDENT, H.D. VEST FINANCIAL SERVICES, IRVING, TX, ON BEHALF OF THE INDEPENDENT CONTRACTOR ASSOCIATION OF AMERICA

Ms. BELLOWS. Thank you, Mr. Chairman and Senators. First of all, I want to thank you for the opportunity to testify on behalf of my company and the Independent Contractors Association of America. I am here today to urge you not to adopt Section 7301 of the administration's bill.

H.D. Vest is in the business of marketing investment products and services, including mutual funds, such as Kemper, Oppenheimer and Putnam. What makes us unique in the financial services industry is the way we operate our company. Our 150 full-time employees at our Irving office do not sell directly to the public, instead they provide marketing support to over 4,200 tax and accounting professionals who offer these products and services to their clients.

In fact, the origin of our company was the realization of our company's founder that CPAs and accountants are perfectly positioned to offer financial services and products to their clients.

These 4,200 tax and accounting professionals are independent contractors. The typical tax professional who chooses to market our products already owns his own tax or accounting business and the income that he receives from providing the services offered through H.D. Vest averages only about $8,000 which is obviously a small part of his overall income. He works on his own schedule. He works out of his own office using his own staff, his own equipment. He pays all of his own expenses and he is more likely to be an employer himself.

The CHAIRMAN. He is sometimes a she.

Ms. BELLOWS. Obviously. I am using he as a neuter term and I can do that since I am a female. [Laughter.]

We do not control or supervise his activities other than to ensure compliance with certain Federal and State securities, insurance and investment advisory laws.

Incidentally, we also provide full health care coverage to our 150 staff employees, full-time employees. We also believe that a great majority of the tax accountants who are associated with our firm as independent contractors have health care coverage through their own companies or professional organizations.

Mr. Chairman and Senators, we know that we are legitimate users of independent contractors currently. But we still have grave concerns about Section 7301.

Section 7301 would give the Department of Treasury broad authority to write regulations pertaining to who is an employee and who is an independent contractor. Because of the disfavor that the IRS has historically shown towards independent contractors, we are very concerned that such authority would severely limit their legitimate use.

This bias was explicitly recognized by Congress when it took the remarkable step of statutorily prohibiting Treasury from writing regulations in this area. Section 7301 would amount to an explicit repeal of the action Congress took in 1978.

If the IRS were to narrow the definition of independent contractors or eliminate that status altogether, which we believe they would, the impact would be significant. Had our independent contractors been classified as employees in 1993, the cost to our company in additional taxes, workers compensation and health care benefits would have been $12.3 million. That represents a staggering 27 percent of our 1993 revenues and is four times our profit for that year.

Mr. Chairman, we recognize that this committee and the Congress are right to be concerned about the companies attempting to manipulate the employment system to avoid the new costs of health care reform. However, we believe that existing law provides abundant protection against exactly that sort of abuse.

While it is true that there are only limited regulations in this area, the key legal questions have been fleshed out in great detail through statutes, legislative history, IRS rulings, court decisions and internal IRS guidance and instructions.

We believe this coral reef of law which has built up over several decades provides the IRS with substantial certainty in pursuing those who would abuse the system. For that reason, we do not believe that additional legislation should be enacted or is required.

However, should you believe that additional steps are necessary to eliminate or reduce abuses, then there are several anti-abuse measures that are available to you. Our company would be happy to work with you and your staff to identify any of those options that are appropriate.

Thank you for the opportunity to testify.

The CHAIRMAN. Thank you. You have come under the line. There you go, very nicely argued. And as I believe the lawyer's term is in the alternative we think you should not do this. But if you decide you should do this, then we think we can help you do it. Very nicely argued. We will get back to this after we have heard the whole panel.

Ms. BELLOWS. Thank you.

[The prepared statement of Ms. Bellows appears in the appendix.]

The CHAIRMAN. Mr. Georgine, welcome, sir.

STATEMENT OF ROBERT A. GEORGINE, PRESIDENT, BUILDING AND CONSTRUCTION TRADES DEPARTMENT, AFL–CIO, WASHINGTON, DC

Mr. GEORGINE. Thank you, Mr. Chairman. Thank you, members of the committee, for allowing me to be here this morning. If I am not mistaken, this is the first time that any committee of the United States Senate has made worker misclassification the subject of a hearing. I want to thank you for recognizing the severity of this problem.

I am submitting a detailed written statement and will summarize it briefly.

The CHAIRMAN. Which we will place in the record as if read.

Mr. GEORGINE. Thank you, sir.

[The prepared statement of Mr. Georgine appears in the appendix.]

Mr. GEORGINE. While this is a technical aspect of the health security bill, its implications are tremendous. In the construction industry, misclassification of workers as independent contractors or as bogus contractors is a growing and insidious practice.

I am not talking about legitimate independent contractors, the American Dream, up by their bootstraps, entrepreneurs or independent contractors in white collar occupations as are represented by some of those who are testifying today.

I am talking about regular, normal construction workers who show up for the jobs and are told that if they want to work they have to do it as contractors, not employees with hourly wages and benefits.

As independent contractors they are paid another way, usually less than a normal rate and usually in some ratio of lump pay per unit of work, like so much to paint a room or so much to hang so many walls of sheet rock.

Workers who accept the status of bogus contractor lose employee benefits—health care, and retirement, and vacation contributions. They are left to cover unemployment insurance and workers compensation costs on their own, as well as make full contributions to Social Security.

With the passage of health care reform the bogus contracting problem could get worse. The health security bill requires that employers cover at least 80 percent of employees' health care cost. This could be a call for the unscrupulous construction employer to avoid health care costs by misclassifying his workers.

A simple way to eliminate the abuses of the classification rules is to adopt Sections 7301 through 7303 of the health security bill.

Let me spend just a few minutes to describe our experience with bogus contracting. Dishonest construction employers use this rule as a way to cut costs. They can reduce a construction bid by up to 40 percent by eliminating costs of decent hourly wages, benefits, and payroll tracks from their estimates.

The chances that they will be caught are very slim. If they are caught the penalties are sometimes avoidable and very rarely severe. Construction workers accept bogus contracting for a couple of reasons.

First of all, they need a job desperately. It is this or nothing and they really do not know what they are getting themselves into. They are not business people. They do not know about estimated quarterly taxes or 1099s. They do not have accountants. They are not in business.

So what do they do? They sometimes do not file income taxes and they fail to make Social Security payments. They do not have health insurance or unemployment insurance or workers compensation coverage. And when the job is over, they and their families have nothing to fall back on. With no intentions beyond trying to feed their families, the construction worker turned bogus contractor continues the fraud begun by the dishonest employer.

This practice has severely affected our industry. Honest contractors are placed at a great disadvantage. They pay their employee benefits. They invest in apprenticeship. They pay for safety programs. Their costs of doing what is right prices them out of the bidding.

Dishonest construction firms win more and more awards. Good contractors lose awards, lose their businesses. Our members lose their jobs. All of society is victimized by bogus independent contracting. Loss of tax dollars at the State's level is estimated to be in the millions; and at the Federal level in the billions. The IRS reports that over $20 billion went uncollected from self-employed individuals in 1992 and this figure includes the independent contractor.

Not only is the tax base eroding, but the practice engenders dependency. Bogus contractors and their families will have to rely on public hospitals and income security programs in lieu of those an employer should have provided and the practice is growing.

Between 1971 and 1991 over half a million construction workers were listed as self-employed. Eighty percent of construction contractors have no employees at all. On one construction site in California there were 60 workers.

The CHAIRMAN. Would you say that once again? Eighty percent?

Mr. GEORGINE. Eighty percent of construction contractors have no employees.

On one construction site in California there were 60 workers, yet no employees. When the IRS visited, every craft worker was listed as an independent contractor. Nearly 25 percent of the construction work force is estimated to be independent contractors. We have attempted to put a stop to bogus contracting through testimony before various House committees and subcommittees, through cooperation with the IRS to uncover violators of Section 530 and a safe harbor escape.

To date, we have been unsuccessful. With the passage of the health security bill, especially with Section 7301 through 7303 left in tact, the issue will be addressed. There will be no confusion, no equivocation about who constitutes and employee. Without those Sections and with employer mandates in the bill to cover at least 80 percent of the employees' health care costs, a provision by the way we support with enthusiasm, the unscrupulous construction employers will have an even greater incentive to misclassify their workers.

We need the provisions to clearly define an employee and with these the loophole will be closed. The harbor once unfairly safe for contractors will be made a safe haven for employees.

Finally, we need a definition of independent contractors. Those factors that we believe defines the legitimate contractor are included in my written statement. They are simple, reasonable standards to apply if one is said to be a self-employed contractor.

I cannot stress enough how badly we need to rid construction industry of bogus contracting. It is debilitating. It robs the worker of economic security and it robs the industry of decent values. Quality craft work, safe working conditions, training of our future work force through apprenticeship are all being abandoned by a fixation on price and the use of gimmicks like bogus independent contracting.

Price has become the sole determinant. Unless owners, developers, and this includes government agencies, start placing a value on quality, safe craft work and the training of our future work force, there will be no work force to turn to when we finally get around to investing in the infrastructure of our country again.

Thank you, Mr. Chairman and members of the committee, for having me here.

The CHAIRMAN. And we thank you, Mr. Georgine. We will get you back for questions.

We are now going to hear from Professor Myron Hulen, who is the principal author of the study, Independent Contractors: Compliance and Classification Issues, which is prepared by the American Tax Policy Institute and which refers to the IRS study estimate that you, Mr. Georgine, said that "understatement of income accounted for a tax gap of about $20.3 billion," which we would be interested inclosing.

Good morning, Professor Hulen, and welcome.

STATEMENT OF MYRON HULEN, PH.D., PROFESSOR OF ACCOUNTING AND TAXATION, COLORADO STATE UNIVERSITY, FORT COLLINS, CO

Dr. HULEN. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to appear here today. I wish also to thank the American Tax Policy Institute for sponsoring us. The views expressed are those of my own and my co-authors, Professors William Kenny, Jack Robison, and Mike Vaughan, and not those of the Policy group.

The CHAIRMAN. Of course.

Dr. HULEN. The following comments are based on two employment tax studies we performed on independent contractor employee classification problems. These studies are relevant to the current discussion about health care reform because the classification problems that occur in the employment tax area are exactly the same ones that will occur in the health care area.

In the first study using actual taxpayer data—we had to become employees of the IRS to obtain this data—we mathematically modeled the decision process the IRS uses to classify workers as independent contractors or employees. In addition, we tested a number of other classification models proposed by industry groups and government agencies.

The 20-factor test the IRS uses to classify workers is very subjective and is not as useful as it might be. It has led to a lot of confusion in the application of this test and some very strong feelings on the part of the public that it is subjectively applied.

We found this 20-factor test can be simplified. A four-factor test which is a subset of the 20 factors can be used to replicate the outcomes that IRS reaches with approximately 93 percent accuracy. Satisfaction of any one of four of these factors will reach this result.

These four factors are ones that are objective. They are easily understood and can be easily applied. We also tested a number of other proposed classification models and found that without exception all would produce fewer independent contractor outcomes than the current IRS test. Again, this was using actual taxpayer data.

This was a great surprise I think to some groups such as the National Federation of Independent Business. They believed their proposed model was much more liberal than the IRS model, but when actual taxpayer data was applied to it, we found that it produced fewer independent contractor outcomes than the IRS would.

It should be noted that depending on the test and the particular factors used, the relative number of independent contractors can be raised or lowered. You can have more employee outcomes or more independent contractor outcomes depending on the factors used. In other words, Congress or the Treasury can adopt a test that produces any number of employee outcomes that it desires.

This has both revenue and social policy ramifications. Independent contractors have a lower compliance rate, as has been mentioned before, creating an annual tax gap of approximately $2 billion by IRS and GAO estimates. This $2 billion tax gap relates directly to the misclassification problem.

Also, the 60 years of social legislation that we have had in this country is largely tied to employment status. For example, Social Security, unemployment compensation, et cetera, is tied to employee status. This becomes an important consideration when adopting a classification test that distinguishes between employee and independent contractor worker status.

The second study we did involved producing a white paper on proposals for administrative and legislative solutions to independent contractor compliance and classification issues. This paper was presented at a roundtable conference in Washington. it was attended by about 75 Treasury, IRS and Congressional officials, representatives of major trade associations and five former IRS Commissioners.

A condensed version of this white paper is submitted here as written testimony.

In general, we came up independently and at approximately the same time that the administration's bill was being written with very much the same conclusions with respect to Section 530 that are contained in sections 7301, 7302, and 7303 of the administration's bill.

Section 530 is not working well in general respects. In particular, section 530 produces the competitive inequities to which Mr. Georgine has referred.

We recommend a number of changes to Section 530 that are outlined in the written testimony and that closely parallel what is in the administration's bill.

Adoption of employer mandated health care will create additional incentives for employers to hire workers as independent contractors. Increased use of independent contractors usually involves loss of benefits to workers as well as probable tax revenue loss because of lower compliance rates of independent contractors.

It should be noted that even without employer mandated health care there has been a very large growth in the use of independent contractors and the contingent work force. That is occurring anyway. As to whether adoption of employer mandated health care would increase this trend, there is no clear answer. It is happening anyway at a very great pace. Employer mandated health care would add just one more incentive to do the same.

Thank you. I will respond to any questions that you might have.

The CHAIRMAN. Thank you very much, Doctor. That is a very striking term, the contingent work force. We appreciate that.

Now, Mr. Miranda, on behalf of the Hispanic Business CEO Roundtable. Good morning, sir.

STATEMENT OF ROBERT J. MIRANDA, PRESIDENT, R.J. MIRANDA & CO., SANTA ANA, CA

Mr. MIRANDA. Good morning. Thank you, Mr. Chairman, Senator Rockefeller, Senator Dole. Thank you for inviting me to appear today before this committee.

Senator Dole, thank you for your leadership involving the Hispanic business community on this important issue.

I am Robert Miranda, chairman of the Taxation Committee of the Hispanic Business CEO Roundtable, a group of the 500 largest Hispanic-owned firms in the United States. In my professional capacity, I am a practicing Certified Public Accountant with R.J. Miranda & Company, a southern California based CPA firm.

As a financial advisor to numerous small and mid-sized companies, I have firsthand experience in the issues that we are dealing with today. A recent national survey of Hispanic-owned businesses revealed that 57 percent of the businesses are opposed to the proposed Health Security Act, employer mandates, and increased government control of the health care system.

The CHAIRMAN. Sir, did you say opposed?

Mr. MIRANDA. I am sorry. It is a survey that was conducted recently, indicated that 57 percent were opposed.

The CHAIRMAN. Opposed, yes.

Mr. MIRANDA. Excuse me.

A majority of Hispanic-owned businesses currently do provide health insurance coverage to all of their employees. My company provides full health care coverage to our employees. We have 50 employees. Although we have experienced in recent years approximately a 15 percent per year increase in our health care premium, the proposed Health Security Act would increase our premiums by 32 percent. This is a cost that I cannot pass on to my clients and remain competitive.

Our community is comprised of small to medium-sized companies. Organized of sole proprietorships, corporations and partner-

ships and S Corporations, the Health Security Act proposals for the definition of employee and the self-employment taxation of S Corporations and certain limited partnerships affects our community in a big way.

These concerns are shared by our counterparts in the general small business community. Our first concern involves a proposed definition of employee rules. The administration's proposal seeks to prevent the misclassification of workers as independent contractors by those businesses that are attempting or would attempt to minimize a payment of the health care premiums.

The proposed Health Security Act gives the IRS authority to issue prospective regulations on independent contractors and in effect redefine the term employee. The proposed repeal of Section 530 of the Internal Revenue Code will have dire consequences in the small business community.

Section 530 of the Internal Revenue Code has provided relief for many years to small businesses, scores of small businesses, who have been challenged by the IRS in audits involving misclassification of employees.

We believe that Congress should conduct a separate review of the independent contractor issue and deny the IRS a broad discretion to come up with these regulations. We do not believe that the Health Security Act should overturn the significant directives of Section 530 without a separate Congressional debate.

The administration can prevent gaming of employment by unscrupulous business owners by improving the matching of 1099 form information against the income reported by independent contractors and sole proprietors. Hispanic business people support full compliance with tax laws. Aggressive prosecution of suspected violators is preferable to jeopardizing the status of all independent contractors.

Our second concern involves the proposed modification to the self-employment tax treatment of S Corporations and limited partnership income. This proposed legislation is intended to subject all earnings from S Corporations and limited partnerships that are involved in a service—related business to self-employment tax and health care premiums.

The administration presumes that all earnings from these businesses represent income from our labor as opposed to a return on the capital invested in our businesses. We are concerned that this proposed change in the tax laws creates more arbitrary and unwarranted redefinitions of income.

Existing recompensation standards are appropriate for addressing the perceived concerns of the administration. Even service-related businesses require capital reserves to operate over the long term. S Corporations and limited partnerships routinely keep earnings in the businesses to finance future operations.

With today's limited availability of growth capital and bank financing, retention of earnings in a business is imperative. Further taxation of these earnings by application of self-employment taxes and health care premiums will hamper small business growth.

Senators, the entrepreneurial spirit is alive and well in the hispanic community. A shining small business example is Alex Mo-

rello, a young Hispanic entrepreneur who started LaPizza Loca, Inc. in southern California in 1986 out of his home kitchen.

Today he manages a thriving publicly-traded chain of restaurants, employing 900 people and realizing annual sales of over $15 million. This sole proprietorship has grown into a flourishing corporation, expanding throughout the southwestern United States.

Entrepreneurs starting out as independent contractors, partnerships and S Corporations represent the American Dream of small business ownership. Some of our most innovative large companies, including Apple Computer and Federal Express, started out as small local businesses.

We urge you to feel the engine of entrepreneurship by rejecting runaway regulation which will only slow our economic growth. Thank you, Mr. Chairman. Thank you, Senators.

The CHAIRMAN. Thank you, Mr. Miranda. I recognize in some of your comments the concerns that Senator Conrad was addressing earlier on.

Mr. MIRANDA. That is correct, sir.

The CHAIRMAN. And now to conclude our panel, Mr. David Scherb, who is the Vice President for Compensation of the PepsiCo Company. Good morning, sir.

STATEMENT OF DAVID E. SCHERB, VICE PRESIDENT—COMPENSATION, PEPSICO INC., PURCHASE, NY

Mr. SCHERB. Good morning, Mr. Chairman. Thank you very much, Mr. Chairman, for the opportunity to speak today. I am Vice President of Compensation for PepsiCo. My health care background includes about 20 years of hands-on experience managing corporate health care plans.

For anyone unfamiliar with PepsiCo, it employs people in three industries. Soft drinks and snack foods are the first two, and they are basically traditional manufacturing industries. Employees at our Frito-Lay and PepsiCola Divisions turnover infrequently and they receive relatively high wages and benefits.

Our third business is restaurants and we operate more stores than anyone in the world, representing household names like Pizza Hut, Taco Bell and Kentucky Fried Chicken.

This industry has relatively high employee turnover, low wages and limited benefits. The jobs are primarily part-time and mostly filled with younger workers. But these are important jobs. The individuals add to the community.

PepsiCo's current employment is 332,000 dedicated men and women across every community in America.

The CHAIRMAN. A third of a million employees?

Mr. SCHERB. Yes, sir. And that does not include our franchisees who also employ hundreds of thousands of employees.

While the large majority have health coverage, many do not. We want everyone to be covered, but not at the expense of their jobs. We have doubled employment in the last 5 years and we want to continue that growth. So PepsiCo clearly has a big stake in solving the difficult health problems we face.

We applaud the leadership of the President and members of this committee. And like many of you we want a health reform bill and we would like to have it this year. But looking at the administra-

tion's plan and similar alternatives we worry about serious unintended consequences. We are concerned about too much government involvement and think that the ultimate goal should be to get government out of health care business wherever possible.

We are especially concerned about the damaging affects of employer-mandated premiums on business, workers and the economy.

Senator ROCKEFELLER. Do you think government being in Medicare is one of those things we ought to get rid of?

Excuse me, Mr. Chairman.

The CHAIRMAN. Feel free.

Senator ROCKEFELLER. Do you want to get government out of health care?

Mr. SCHERB. I said wherever possible, not necessarily immediately and not necessarily to do damage anywhere, but to the extent possible, Senator.

The CHAIRMAN. What about Medicare?

Senator ROCKEFELLER. You think Medicare is useful? Do you think it is useful?

Mr. SCHERB. I think it is very useful.

Senator ROCKEFELLER. What is your overhead at Pepsi? What is the cost of doing business at Pepsi? What is your administrative overhead?

Mr. SCHERB. Our administrative overhead?

Senator ROCKEFELLER. Yes.

Mr. SCHERB. In terms of labor costs it is about a third. And then, of course, there are other costs like the cost of products, et cetera.

Senator ROCKEFELLER. And Medicare is 3 percent. I am sorry for interrupting you.

The CHAIRMAN. That will not be chargea against your time.

Mr. SCHERB. Thank you. I appreciate that.

Our basic mandate message is pretty simple—beware of the unintended cost of good intentions. Employer mandates are a hidden new employment tax and are an reggressive one at that.

As the CBO and nearly all economists agree, companies do not pay the cost of mandates, workers pay through lost jobs and reduced wages. Take Pizza Hut for example. The administration's employer mandate would increase labor costs about 20 percent or about 6 percent of sales. Some say we could raise prices by that amount, but the same constituents that tell you they do not want to pay higher taxes have shown us they do not accept higher prices. They will simply eat more often at home. We estimate increasing prices would cut sales 15 percent and cut jobs as well.

We could simply try to sell more pizzas. But a 6 percent cost increase would require a top line sales increase of $850 million a year, a 33 percent sales increase over 1993.

Senator DOLE. How many pizzas?

Mr. SCHERB. About 120 million pizzas, Senator. Per year.

The CHAIRMAN. A 120 million pizzas. Now we are getting serious here. [Laughter.]

Senator DOLE. I read that in this statement.

Mr. SCHERB. Our only realistic option will be to take costs out of the system through automation and other means. That means jobs and wages.

A recent study by CONSAD Research estimated that under the administration plan 23 million Americans would end up getting less pay and 850,000 would lose their jobs. Nearly half of the lost jobs would come from large companies.

Let me emphasize, the employer mandate is not an issue between small and big business, it kills jobs in companies of all sizes, particularly in the service sector. Ironically, the biggest losers would be low-wage workers. One of the primary groups health reformers intended to help.

This is a particularly disturbing result that highlights why the employer mandate is inherently unfair. It puts government squarely in the position of choosing winners and losers in the economy and the job marketplace. That is because it creates huge economic distortions as billions of dollars change hands among companies and individuals that already have insurance.

The employer mandate is not the panacea for the universal coverage that it has been advertised to be. It cannot be. Almost by definition because a large number without insurance are either unemployed or uninsured. We think there is a better way to control cost and achieve universal coverage. We are encouraged by the increasing number of proposals that embrace a common formula for success.

First, enact those reforms that will control costs and provide security for the 85 percent of Americans who already have coverage. That is what Americans want most.

Second, for the 15 percent who do not have coverage, remove the barriers to access by requiring all employers to offer plans and by providing means tested subsidies directly to disadvantaged individuals.

We believe the reforms in steps one and two would get the uninsured down to between 6 and 8 percent of the population.

Step three targets this group and only this group to close the gap and achieve universal coverage. Our particular version would automatically enroll the uninsured in a plan whenever they seek care. This includes disadvantaged individuals who do not sign up because of education or language barriers stood in their way. They would be steered to the subsidies they qualify for and get special help signing up for private insurance.

Also, free riders, those who have the means to buy insurance but decided to take their chances without it. They would be enrolled in a plan, too. And they would pay a financial penalty until they signed up for private insurance.

The solution targets only the small percentage remaining uninsured after initial market reforms are in place. It does not turn the world upside down for the 85 percent of Americans who already have coverage today and it does not set in motion another expansion of government bureaucracy or social entitlements.

Based on most of the polls we have seen lately, we believe it is a solution that would receive broad public acceptance, not just when the bill is enacted, but also down the road when the impact is felt.

That concludes my summary, Mr. Chairman. Thank you very much for the opportunity.

[The prepared statement of Mr. Scherb appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Scherb.

Now if I could just make one comment. Of all the persons whose influence is to be heard in these hearings, I do not know anyone more—I think Professor Hulen would be interested to know this—that Robert K. Mertin who propounded the law of unintended consequences of purposeful social action in 1935 is alive and well and meets his seminars at Columbia University to this day. We have heard about unintended and we were listening.

Senator Dole?

Senator DOLE. Thank you, Mr. Chairman.

Ms. Bellows, who makes up the Independent Contractor Association? What kind of businesses? How many industries are represented and what is the average size of the business?

Ms. BELLOWS. I do not have the average size, but it is a wide coalition of several industry groups. It is not specific to any industry and it is represented by several industry groups across the country.

Senator DOLE. I think it might be helpful if you just furnish that information.

Ms. BELLOWS. I would be happy to furnish that to you.

Senator DOLE. I did not have Mr. Georgine or Mr. Hulen's statement earlier.

I want to ask Mr. Miranda, too, what kind of recordkeeping requirements will the administration's bill impose on small business and how do you advise your clients on these issues?

Mr. MIRANDA. Well, on the one hand as a practicing CPA we welcome more recordkeeping for our clients because it creates more business for us.

On the other hand though——

The CHAIRMAN. I think that wins the prize for candor. [Laughter.]

Mr. MIRANDA. On the other hand, with respect to the burden that it will place on small businesses, we believe in examining the draft of the bill, that there will be significant new monthly reporting requirements that have to be provided by businesses; complex computation of a number of employees in the preceding month; adjustments of employees into full-time equivalents.

We believe it will be an extensive recordkeeping burden on small business to comply.

Senator DOLE. But again as you indicated, and both Dr. Hulen and Mr. Georgine, that you do not object to tightening up and going after some of the people who abuse the process.

Mr. MIRANDA. We firmly believe that the abusers should be prosecuted and we believe that there are mechanisms presently in place such as the 1099 information reporting system with improved compliance, improved matching by IRS against the independent contractor returns will achieve some of the desired objectives of the administration.

Senator DOLE. I want the record again to emphasize Mr. Scherb has had about 20 years experience in corporate health care plans. I know I visited with him about the proposal he has made to the committee. I think it does deserve a serious consideration.

I have been talking about Pizza Hut for a long time because they are headquartered in Wichita, Kansas. I think some may wonder, and I would ask Mr. Scherb the question, employer mandates, it

is fairly easy to make the case for small business—5, 10, 8 employees—but how do you make the case for 330,000 employees?

I read in your statement that you may be the first corporation to reach a million employees maybe as early as the year 2000, according to Fortune magazine.

Mr. SCHERB. Well, thank you for the compliment. I would like to respond to that. I guess one of the things that I think you have to take into consideration is that people do not realize that there is growth among large corporations. Many of the jobs that have been created in the last 10 years have been in the service sector.

If you look at the Fortune 500 magazine survey of industrials, indeed, 4 million jobs were lost in that group of large companies. But there is another group called the Service 500 and that Service 500 represents the retail industry, the financial industry, the restaurant industry, real estate and other service industries. And, indeed,that group has grown jobs by 10 million in the last 10 years, from 1982 to 1992. So there has been a large net increase of large companies.

Now the issue, to get to your point about the lost jobs and why it is an issue for big companies is the nature of service jobs. Even when a company is large, a company like ours, service jobs have high labor costs and low margin. They typically have a very elastic demand for their product, whether it be pizza or going to Disney World or entertainment or any number of service jobs. People do not necessarily need that product. They have alternatives.

So if you look at large companies, they suffer the same kind of economic problems from increasing prices as a small employer. Now, in fact, they are even organized like small employers. If you look at us, we have restaurants all over the country in small locations. That is where we compete head-to-head with small business.

And any service business that has many small locations looks at each one in profitability to determine whether they are going to open it or whether they are going to close it.

So they compete on a very local basis. So when you take large companies and you cap the cost on small companies and do not large or you take large companies and you look at them as if they can borrow from Peter to pay Paul from one industry to another, you are not really seeing where most of the problem is, which is a large service business that has every problem that a small business has in every little community where it operates.

Senator DOLE. Well, in visiting with the Pizza Hut people in Wichita—and correct me if I'm wrong, I believe there are about 185,000 part-time employees. And if they are covered under the President's plan and maybe some of the other plans, it will increase the cost, and as I understand it, probably reduce the number of part-time employees and deal in other ways, either overtime or full-time employees.

Well, that is the point they make. Is that an accurate reflection?

Mr. SCHERB. Yes, it is. The fact is that under the President's plan it would increase our labor cost about 20 percent and actually a little bit more than 20 percent. There are not too many businesses in any industry that can take a 20 percent increase in labor.

Senator DOLE. What portion of those young people are covered by their parents, about half or more?

Mr. SCHERB. Actually, about 71 percent are currently covered elsewhere and then we offer a plan at Pizza Hut as well which picks up some of the additional 30 percent, but not all of them. So there are people that are still left. That is why we are very adamant about reform and we are for a positive reform solution.

Senator DOLE. I think the record might reflect too some of the success stories you have had in PepsiCo generally where people started off maybe as a waiter or waitress and ended up as a proprietor. I know that has happened. I can think of some people I know who have had that success in my State.

Mr. SCHERB. Well, I am one. When I was in college I ran a Kentucky Fried Chicken at night. It is not in my testimony. But I worked my way through college as a Kentucky Fried Chicken night manager. The first place I learned how to manage people and learned what it was to be responsible and show up for a pay check.

I think, you know, while everyone does not necessarily go on and become a Vice President obviously of a corporation, I think people under estimate the importance and the flexibility of the jobs in the restaurant industry. Most people do not realize that more than half the people under age 35 in this country have worked in food service, more than half the adults.

It is not a dead end job. I think another interesting statistic is that out of family households that make $50,000 or more in this country, 38 percent have worked in food service. That indicates to me that when people work in food service, even if they do not stay there for a career, these are hard working people that are going to go on and do something else. They have gotten their basic training in employment in those jobs.

Senator DOLE. Could you furnish in more detail your sort of uncompensated care plan? Is there more detail?

Mr. SCHERB. In my testimony there is a fair amount of detail. That plan is intended as something that is really possible to add to a number of proposals, including a number of proposals before this committee in terms of health care reform.

It is one idea, but we think it is a good one. We think it adds some new things to the debate. For example, one of the things that concern us is that everyone has been looking for solutions that may be bigger than necessary in that they try to change or mandate the behavior and the cost of the 85 percent that already have coverage in this country. That seems to cause a lot of economic disruption.

Our feeling is that you have a problem that involves 15 percent, that we think that you can shrink, you can get rid of by most of the things that we would do to take care of cost and access. Our idea is to then focus where the real problem is on the last 6 or 7 percent, and let us focus on that group and make sure that they do get universal coverage.

We think the most efficient way to do that is not to audit them through the IRS and catch them a year and a half later, but to enroll them the minute they interface with the health care system up front, to reimburse providers. Do not make providers and the hospitals give uncompensated care. Let us get rid of uncompensated care. But then enroll those people as quickly as possible and get them direct help.

Senator DOLE. Finally, I did not have copies of either Bob's statement or Dr. Hulen's. I think they will be made available and we may have some follow-up questions if we have a chance to review those.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. Well, thank you, Mr. Chairman, very much.

Mr. Scherb, how much money does Pepsi make? What were your profits last year?

Mr. SCHERB. About $1.5 billion.

Senator ROCKEFELLER. $1.5 billion?

Mr. SCHERB. Yes.

Senator ROCKEFELLER. You said that companies do not pay the cost of mandates, workers pay through their lost job and reduced wages, did you not?

Mr. SCHERB. Yes, that is true.

Senator ROCKEFELLER. Now do you know what the Congressional Budget Office is?

The CHAIRMAN. That is what you said?

Senator ROCKEFELLER. Yes.

Mr. SCHERB. That employees pay through reduced wages and lost jobs.

Senator ROCKEFELLER. Do you know what the Congressional Budget Office is? Do you have any sense of them, whether they are truth tellers or what?

Mr. SCHERB. I think they tell the truth as they see it.

Senator ROCKEFELLER. All right. They said that the President's health care bill would have a negligible effect on jobs. Then they said that businesses would have an additional $20 billion in 2000 and $90 billion in 2004 to pass along to workers in higher wages. Their words, not mine.

They say that over the past decade rising health care costs have in fact been the major cause of stagnating worker wages. Would you disagree with that?

Mr. SCHERB. No, I would agree that as health care costs have risen it has depressed employee wages. I think it makes my point about the fact that health care costs are paid by people and not by companies.

Senator ROCKEFELLER. What about all the money that is going to get passed along? You say you respect their work as far as you know it. $20 billion in 2000, $90 billion in 2004 gets passed along to workers in higher wages.

Mr. SCHERB. In 2000?

Senator ROCKEFELLER. $20 billion in 2000 and $90 billion in 2004.

Mr. SCHERB. I think that is one of the big problems in the macro economic studies. By 2000 employers will all react to this employer mandate. All the damage will be done long before 2000. When we study this in 2000 and look back on it, I am not sure, other than an academic exercise, whether it will matter a whole lot to the folks that suffered whether or not the CBO was right.

I would also say that the CBO used the President's assumptions. They had a few assumptions in their study and that is that the plan would, indeed, get costs down to the CPI in this country which

will be the first time anyone in the world has been able to accomplish that.

I think given the assumptions the CBO did arrive at those conclusions. But that still does not change the fact that more immediately people are going to suffer a whole lot and I think unnecessarily.

Senator ROCKEFELLER. Let me go on to another point. When you quote your job loss you are quoting from a study paid for by the National Federation of Independent Business, are you not? You did not say that.

Mr. SCHERB. CONSAD Research, which was engaged by actually the NFIB and others. Not just the NFIB. They were a contributor.

Senator ROCKEFELLER. Would it not have been reasonable to say that they are out to kill health care reform?

Mr. SCHERB. Well, I think that you do not just have to look at CONSAD. If you look at Lewin Associates.

Senator ROCKEFELLER. But you did look at COMSAD.

Mr. SCHERB. Oh, sure. I quoted it in my statement.

Senator ROCKEFELLER. So in the future will you say that it was paid for by the NFIB?

Mr. SCHERB. It was actually paid for by the NFIB and a number of companies and other organizations. But yes I will, sir.

Senator ROCKEFELLER. All right. Have you ever heard of the Employee Benefit Research Institute?

Mr. SCHERB. Yes, I have.

Senator ROCKEFELLER. Do you have any regard for them?

Mr. SCHERB. Yes, I have regard for them.

Senator ROCKEFELLER. You do. They estimate that the President's plan would create more than half a million jobs. Any comment?

Mr. SCHERB. What time frame?

Senator ROCKEFELLER. I do not know. Let us say by the year 2000.

Mr. SCHERB. Again, the problem is that most of these macro economic studies deal with a 5 to 10 year time frame. I do not know. Maybe in the year 2004 or 2010 there will be jobs that will ultimately be created. But the jobs that will be lost, as I have testified, will be——

Senator ROCKEFELLER. Which you say will be lost.

Mr. SCHERB. That is correct.

Senator ROCKEFELLER. You talk about a mandate—I mean, you talk about a three—part system to cure you. You tout yourself, at the beginning, by saying that you are one of the most innovative——

You say you have a reputation as a health benefit innovator and yet everybody in Purchase, New York has wonderful health insurance, but your people in Taco Bell, KFC, and Pizza Hut do not have any health insurance.

Mr. SCHERB. Well, they do. The part-time workers do not sign up for it with us as much because we do not pay for it as much as we do full-time. You are correct there. Yes.

Senator ROCKEFELLER. So the part-time workers do not?

Mr. SCHERB. But in terms of the part-time workers who do not sign up with us. It does not mean they do not have coverage. But they may have it through another party.

Senator ROCKEFELLER. In other words, if somebody else is paying for it they have it. But if nobody else is, then they do not have it. But that is okay by you?

Mr. SCHERB. No, it is not okay by me. As I said, there is a percentage—it is not a majority—but there is a percentage of our people that do not have health coverage which is exactly why I am here, because we think that we do need reform and we are very much in favor of universal coverage. We think we need to achieve it, but not with——

Senator ROCKEFELLER. I know you testified in Texas several weeks ago at an Alliance for Health Reform event and you were very much against all of this.

EBRE also said that the average business with nine employees and an annual average salary of $13,000 per person would actually save more than $12,000 a year in health care costs. Now that is if you have a mandated system and you take the $250 billion over a period of time of waste out of the trillion that we are spending every year.

You see, you are not looking at the whole system. You are just figuring, well, we will take the uninsured people here and then do some there. But you are not looking at any systemic change.

What you are saying is a voluntary system works. A voluntary system does not work.

Mr. SCHERB. No, I am not suggesting a voluntary system. I was suggesting that employers should be required to provide coverage, just not to pay for it and be specified how much.

Senator ROCKEFELLER. To be required to provide it but not pay for. So then who would pay for it?

Mr. SCHERB. Well, the employers and the employees will pay for it. Employees ultimately always pay for it because they are the ones that are working. The employer is the accumulation of its employees, other than stockholders.

And if you pass on the costs straight through to stockholders and profits you are going to lose stockholders. So ultimately the only people that work in this country and earn the money are employees, so it always gets back to them.

But what I am saying is you will always have, as you have had, employers sharing responsibility whenever they can afford it. That is why we have 85 percent of the people covered now. Employers will allocate compensation over to the benefit side for the same reasons that employees have wanted that. And they have done it in the past because we have tax incentives and because of competition and that is what people want.

Senator ROCKEFELLER. You have not answered my question yet about the average business with nine employees and an average salary of $13,000 per person would actually save more than $12,000 a year in health care costs according to EBRI.

If I send that to you, would you respond to that?

Mr. SCHERB. I will respond to it now. I think the problem is that it assumes that you are going to stay with a 3.5 percent cap and

I do not believe the government is going to keep a 3.5 percent cap in place for any length of time. I think it is unrealistic.

That all assumes that the government subsidizes most of the cost. The cost did not go down to 3.5 percent. The government is picking up the tab. It is estimated by COMSAD that is about an $80 billion tab a year, subsidies to business. That is a lot of money.

It seems to me inefficient. You should give the money directly to needy individuals on a means tested basis rather than giving companies or small business, who may not even need it, on a non-means tested basis large subsidies.

Senator ROCKEFELLER. Do you know in Hawaii where they have had employer mandates, employment in eating and drinking establishments has risen 25,000 to 42,000 in just a little over 10 years?

Mr. SCHERB. That is not necessarily attributable to the fact that they have had mandates. It is attributable to a lot of things. Eating and drinking establishments have gone up in terms of serving the public across the industry and it is primarily due to the fact that they have figured out how to keep their prices low and to encourage people to come in and eat.

Senator ROCKEFELLER. Can you do that?

Mr. SCHERB. Pardon me?

Senator ROCKEFELLER. Can you do that?

Mr. SCHERB. That is exactly what we have been doing for the last 5 years. We have not increased prices for 5 years because we found that when we increased prices it chases people out of the restaurants.

Senator ROCKEFELLER. To where?

Mr. SCHERB. Home or to grocery store to buy a frozen pizza or a boxed lunch when they go out on a picnic instead of stopping by KFC or Pizza Hut.

Senator ROCKEFELLER. But Hawaii has made it work in a non-voluntary system. One of the lowest unemployment rates; small business bankruptcy rates very, very low; new start-ups very, very high.

Mr. SCHERB. Well, I think a couple comments on Hawaii. I think first off the Census studies and other studies have shown that after 20 years of an employer mandate the coverage is still down in the low 90's. So it does not automatically mean if you have a mandate that works.

Second, I think if the rest of the United States was like Hawaii in terms of its climate, in terms of its high employment and in terms of its prosperity, maybe the problem would not be as great as we have it right now. We would have higher coverage.

But I mean comparing Hawaii to places in the northeast with higher health care costs and respiratory disease and places with higher unemployment in large cities like New York, I do not think they are very comparable, anymore than Switzerland is comparable to the United States.

Senator ROCKEFELLER. No, Switzerland is comparable to West Virginia.

Mr. SCHERB. In terms of its beauty, Senator, I agree.

Senator ROCKEFELLER. Yes.

You say that an employer mandate—Mr. Chairman, I am almost finished.

The CHAIRMAN. Take your time.

Senator ROCKEFELLER. An employer mandate would just clobber jobs right away, did you not?

Mr. SCHERB. I think that is exactly what would happen.

Senator ROCKEFELLER. So I guess you make the assumption that if we passed a bill that we phased in 100 percent, it would have to be effective 100 percent right way?

Mr. SCHERB. No, I do not make that assumption. But I assume when you pass a bill with an employer mandate that whether you phase it in immediately or not—and companies are going to immediately respond by changing their 1-year plan and their five-year plan—they will immediately judge the impact.

And since employees currently in this country, as well as businesses, are looking at a relatively 3 percent increase in wages a year, if you are going to pass something on in terms of cost and wages, which employers will do, it is not going to be something that is easily hidden and it is not going to be something that they are going to be able to wait until after the impact on business.

So I think businesses will respond as we would by automating and other things pretty quickly, even before the mandate goes into affect.

Senator ROCKEFELLER. Well, I think you are scrambling a little bit on that. I would hope that Pepsi would not. But you sort of disparage macro economic models.

If you had profits of $1.5 billion last year, you know, I am sure there is somebody up there that can figure that out if you have been working on this for 20 years and you think that you are one of the most innovative around by your own estimation.

You see, we would phase this in over a period of years. If the President's bill passed, there would not even be an alliance set up until 1996. Did you know that?

Mr. SCHERB. Yes, I did.

Senator ROCKEFELLER. And so that it could be phased in over a period of five or six or 7 years. So it might be the year 2000. So you are saying if we phased in a mandate by the year 2000—and you knew it was all there in cold, hard writing—that PepsiCo, one of the largest companies in the world—incidently I have never heard anything from Coca Cola criticizing any of this—that PepsiCola could not handle this.

You are not talking for the other people at the table. You are saying PepsiCola could not handle this.

Mr. SCHERB. No, that is not what I am saying. I am saying PepsiCola could handle this. PepsiCola would have no problem handling this because what we would do is——

Senator ROCKEFELLER. Then why do you not do it?

Mr. SCHERB. You are right about the phase-in.

Senator ROCKEFELLER. Then why do you not do it? Why do you not give people insurance?

Mr. SCHERB. What we would do is that we would have to automate and find other ways of reducing our costs. Because if we increased prices those same people are going to lose their jobs anyway. So you are absolutely right, we would have time to phase it in and PepsiCola would not go away. We make $1.5 billion. But this bill, the President's bill, would cost us well over $300 million

because the cost is also big. We have a lot of people. We are labor intensive.

In terms of our restaurant divisions it would wipe out two-thirds to three-quarters of our profits of those restaurant divisions and you cannot operate a business when you cannot earn a profit. People will not invest in you.

So we would not suffer in the long run and we would phase it in. But what we would do is we would automate our restaurants and that means ultimately lost jobs.

Senator ROCKEFELLER. Let me just ask you this one final question because you have already said, as has your Chief Executive Officer—I have talked with him about this, too—you just despise the concept of government. I understand that.

That if you have these temporary employees who do not have health insurance now, it would not be very difficult to find out which ones were not being covered by other employers. Why do you not go out and find those folks and give them health insurance, your own people? Why do you not just do that?

Mr. SCHERB. First, we do not despise government in any way, shape or form. In fact, you know, one of the—if we despised government, I would not be here trying to work with the committee and being willing to stick our head up and speak out on an issue which I think is, you know, pretty brave on the part of our Chairman to let me do it.

Senator ROCKEFELLER. Yes, but you are trying to push a voluntary plan.

Mr. SCHERB. I agree with most of the alternative plans that are presented, including on this committee, including the Chafee-Dole plan, the Breaux—Durenberger plan. I am not pushing something that is radical.

Senator ROCKEFELLER. You are pushing the tax cap, are you not?

Mr. SCHERB. I think a tax cap is one alternative and not a bad one for raising revenue to help fund subsidies for the poor.

Senator ROCKEFELLER. Whereas, you think 65 percent of the revenue would come from people making $50,000 or more. The fact of the matter is that the tax burden would fall most heavily on those making between $15,000 and $30,000 a year. You are quite wrong.

Mr. SCHERB. Not according to the CBO. The CBO says that a tax cap, including an exclusion on the employee, would raise almost all the money above $40,000. That is in their report, not mine. That is where I got the numbers.

Senator ROCKEFELLER. Well, let us then let EBRI and CBO talk because I think that you are targeting the wrong group of people.

Mr. Chairman, I haven no further questions and I appreciate your indulgence.

The CHAIRMAN. That is what we are here for. But if you will not mind if I return to sort of the initial question in this hearing, which is the classification of workers as employees.

Senator ROCKEFELLER. Mr. Chairman, I was only saying that because Mr. Scherb made a tremendous point at mandates in his testimony.

The CHAIRMAN. He did indeed and you were absolutely right to pursue it.

But we have a question which I have to tell you I was not aware how—it is a big question that Bob Georgine raised. Professor Hulen has come here with a proposal from a nonpartisan group at the Tax Institute with a four—point condensation of the 20-factor test. We are onto the subject. It is going to come. The President's health bill will require a redefinition of this matter. Just quite independently we may want to do this. You did not start out to do this in the context of the President's health bill, but there you are.

Could I ask, I do not know how familiar each of you may be, but with the proposal of Dr. Hulen, and I should say William Kenny and Dr. Robison and Dr. Vaughan, your co-authors, but the four-point test—could I ask Mr. Georgine and then I will ask Ms. Bellows—do you have any feeling about that as a mode of—would it affect the concerns that you have—80 percent of contractors with no employees and the contingent worker? I found that term very useful.

You do not have to. Maybe you did not have it before you.

Mr. GEORGINE. I do not know.

The CHAIRMAN. All right. A careful collective bargainer does not agree to something he has not read. But could we ask you if you would take a look at it and let us know.

Mr. GEORGINE. Yes, I will.

The CHAIRMAN. Let the committee know. Because we had Secretary Samuels saying we want him to have the advice of the committee. We want to have legislative history. We want to do this thing right and it is not going to be done quickly.

Ms. Bellows, do you have a response?

Ms. BELLOWS. Well, I have not read the report that you are talking about or the recommendations there. But I will say that——

The CHAIRMAN. You are not alone. I have not read it either.

Ms. BELLOWS. I will say that I think removing the subjectivity for the application of the 20 common law factors is important.

The CHAIRMAN. Yes.

Ms. BELLOWS. And that is something that should be considered by Congress and not given over to the IRS given their bias against independent contractors.

The CHAIRMAN. Do you think, Dr. Hulen, would you agree that there is a bias in the IRS? Just give us a professional reading.

Dr. HULEN. Senator Moynihan, again I come from an independent standpoint on this. I do think that the IRS does have an institutional bias in that by actual count, in 97 percent of the cases where they examine worker status, they classify workers as employees.

The CHAIRMAN. And not as independent contractors.

Dr. HULEN. That is correct. And second——

The CHAIRMAN. 97 percent.

Dr. HULEN. Yes, it is 97 percent by actual count.

The second kind of evidence relates to factual disputes. When the IRS is given a case, both the worker and the firm supply information to the IRS. Occasionally there are factual disputes between the worker and the firm and again by actual count, roughly 80 percent of the time the IRS chooses the facts that will support an employee outcome.

So I think you have to conclude there is an institutional bias.

The CHAIRMAN. All right. Certainly there is a pattern of deciding in one direction. It may be that issues that arise are of that mode. I think we will ask them.

Mr. Miranda, do you have a view? Ms. Bellows, we heard you.

Mr. MIRANDA. Not having read the four proposed rules, I believe the issue has to do with—it is difficult to establish a cookie cutter approach to any issue involving independent contractors versus employees.

There is a whole body of case law. There is Section 530 that has functioned effectively in the past 16, 17 years. I believe it requires more examination before we change this body of law.

The CHAIRMAN. You heard Secretary Samuels.

Mr. MIRANDA. I did, yes.

The CHAIRMAN. He did not come here and say we have made up our minds and we know what we are going to do and we are going to just do it our way. I mean, he was very open to these things.

Mr. MIRANDA. I did hear that and I think that is very necessary to continue the debate on the issue before a decision is made to grant the IRS——

The CHAIRMAN. Because we have not just the health care issue but the issue that Mr. Georgine very properly raises. It is your view that more today, considerably more work in the construction industry involves the assertion that an individual craftsman is in fact an independent contractor?

Mr. GEORGINE. Becomes a contractor at the request of the employer, the mandate of the employer.

The CHAIRMAN. Yes, if you want the job this is what you do it on.

Mr. GEORGINE. In order not to pay any benefits.

The CHAIRMAN. Well, you fellows started that when you insisted on owning your own tools, you know. That is an important thing about the building trades, you own your own tools.

Well, again, if we could get some counsel from you on this we would appreciate it.

Mr. MIRANDA. Well, basically my position is that there is a need to closely examine it before the rules are changed. That will require more examination of the alternatives perhaps, the alternative proposed.

The CHAIRMAN. Well, take a look at the proposal.

Mr. MIRANDA. I would be happy to review it carefully and send in my suggestions.

The CHAIRMAN. We will hear from you. We will print any responses you have in our hearing.

Dr. Hulen?

Dr. HULEN. Senator Moynihan, this is just one model. There are many that could be proposed that would be fairly objective and so forth. But this is one approach. Others would be equally acceptable. And again, you can move the equilibrium point between employee or independent outcomes either way you want depending which test you actually choose.

The CHAIRMAN. What we want to be is be, you know, our invariant injunction to be predictable and try like cases in like manner and get as little subjectivity as possible.

Mr. Scherb, does PepsiCo have a view?

Mr. SCHERB. You may be happy to know I do not have expertise in this subject. We do not contract our work. Our employees are our own and I really do not feel I have anything to add.

The CHAIRMAN. You do not have to be an expert on everything.

Mr. SCHERB. Thank you.

The CHAIRMAN. Well, this has been a very useful morning.

Senator ROCKEFELLER. Mr. Chairman?

The CHAIRMAN. Yes, sir.

Senator ROCKEFELLER. Could I just make one clarification?

The CHAIRMAN. Yes, sir.

Senator ROCKEFELLER. This was clarified to me. Therefore, I can clarify it to Mr. Scherb. That the difference between the EBRI study and the CBO study, the EBRI study—and my point therefore holds—the EBRI study looks at a percentage of a person's income. They would pay a larger percentage of their income in new taxes under a tax cap, a percentage of their income.

The CBO side looks at total revenues from a tax cap. It goes from there. So one is the total revenue; the other is the total income.

The CHAIRMAN. That is clear. That is a distinction. Sure.

Mr. SCHERB. I will look into both those studies. Thank you, Senator.

The CHAIRMAN. Well, thank you, Senator Rockefeller.

Thank you all for a good factual and usefully contentious panel. With that, we will continue on Thursday.

Tomorrow the committee will meet tomorrow morning at 10:00 and the CBO will give us—Mr. Reischauer—his CBO report on Mr. Breaux's legislation.

[Whereupon, at 12:32 p.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF PATRICIA A. BELLOWS

Good morning. My name is Patricia A. Bellows, executive vice president and a member of the Office of the President Executive Committee of H.D. Vest Financial Services. I am testifying today on behalf of my company and the Independent Contractor Association of America ("ICAA"), a national trade association with members throughout the United States.

H.D. Vest is in the business of marketing financial services products like mutual funds. Our 150 employees at our headquarters in Texas do not sell directly to the general public, but rather provide marketing and support services to 4,200 tax and accounting professionals, including more than 200 in New York State. These tax and accounting professionals—who operate their own accounting small businesses quite apart from their work for Vest—then sell the products to 1.5 million American families and businesses.

Incidently, we provide complete health care coverage for our 150 employees. Although we do not know for sure because we have little control over or knowledge about certain characteristics of the tax and accounting professionals who market our products, we believe the vast majority of them are covered by health insurance provided through their own companies or trade associations.

H.D. Vest is your basic American business success story. The company was founded by Herb Vest in 1983. Since then, we have grown from a very small business into a thriving concern. H.D. Vest was included in Inc. magazine's 500 fastest-growing companies in 1989 and 1990. Herb Vest has been profiled in *Success* and *Forbes* magazines and has been named one of the 100 most influential people in accounting.

What makes us unique among financial services companies is the way we operate. The typical tax professional who chooses to market our products already owns his own tax preparation or accounting business. He has an existing client base, is an employer himself, and, in most cases, would be quite successful without his relationship with H.D. Vest. We are only a supplement to his existing operation. The income he receives from H.D. Vest averages about $10,000, only a fraction of his overall income. We provide little or no oversight other than compliance with federal and state laws and regulations governing securities, insurance and investment advisory services. We compete with other financial services companies to provides services to these tax professionals. In many ways, we work for them more than they work for us.

In that sense, these individuals are the ultimate independent contractors. We provide little or no control over their activities. They work on their own schedule out of their existing business using their own equipment and staff. They set their own hours and cover their own expenses. They shoulder the entire risk of their enterprise and market their financial services products to the general public, particularly to their existing customers. We believe they are textbook examples of independent contractors.

Notwithstanding our status as legitimate users of the independent contractor designation, we still have grave concerns about key provisions in S. 1757, the President's Health Security Act ("HSA"). In particular, we are concerned about Subtitle C of Title VII, which grants the Secretary of Treasury broad authority to redefine the independent contractor designation and which rewrites existing safe harbor provisions. We believe the proposed changes in these sections may be well-intended, but go far beyond what is necessary to ensure that companies do not manipulate the employee status of workers to avoid the significant new costs of health care reform.

These provisions have the potential to substantially revise decades of existing law, cause the elimination of thousands of jobs, significantly increase the burden on American business and yet not achieve the objectives for which they were included in the HSA.

GENERAL BACKGROUND

1. The issue: workers are either employees or independent contractors

An independent contractor is, in its truest sense, a sole proprietor. The sole proprietorship form of business is in many instances an individual's gateway to entrepreneurship. This is certainly true of the many tax and accounting professionals whom H.D. Vest serves. An individual starting his or her own business does not always do so in the corporate form. There is no question that the entrepreneur who chooses the non-corporate form of business is no less a business than his or her counterpart who opted for the corporate form. However, the Internal Revenue Service ("IRS") has demonstrated a general disfavor of the unincorporated form of entrepreneurship.

Laws that affect the relationship between an employer and an employee reflect a recognition of the fact that the control exercised by a business over its employees is substantially greater than the amount of control the business exercises over non-employees, i.e., sole proprietors. The degree of control that is exercised over a worker by a business has traditionally been the critical factor in distinguishing between employees and independent contractors.

Under the Internal Revenue Code ("Code"), a business using employees is subject to several employment tax withholding obligations. Such obligations are intended to ensure that the employees comply with their federal tax obligations. For example, an employer is obligated to withhold federal income tax and the employee share of Federal Insurance Contribution Act ("FICA") tax on wages paid to its employees. Such a business has no similar obligation with respect to amounts paid to independent contractors from whom it purchases services.

The Code also imposes additional tax obligations on a business that uses employees. For example, an employer is obligated to pay the employer share of FICA tax, and the Federal Unemployment Tax Act ("FUTA") tax with respect to wages paid its employees. In contrast, the business would incur no such tax obligations with respect to sums it pays independent contractors for services rendered. Some have alleged that a business is likely to mischaracterize workers as independent contractors simply to avoid the additional costs. That concern has increased as the Clinton Administration has promoted a program of health care reform, which could require companies to provide health insurance to their employees, but not independent contractors.

2. The Congress has had to restrain the attack on independent contractors

Beginning in the 1960's, the IRS undertook an aggressive audit approach seeking to reclassify independent contractors to employee status. In such cases, if the IRS were successful in "reclassifying" the independent contractor, the service recipient would become liable for the employment taxes that would have been owed had the independent contractor been an employee. Naturally, in addition to the back taxes asserted there would be penalties and interest.

Congress responded to the IRS's auditing of independent contractors by enacting section 530 of the Revenue Act of 1978 ("Section 530"). Section 530 essentially immunizes a business against its treatment of workers as independent contractors being challenged by the IRS, provided that prescribed criteria are satisfied.

The IRS's motivation during the pre-1978 era for seeking reclassifications was attributable to alleged compliance problems, and to the disparity between the amount of FICA taxes versus Self Employment Contributions Act ("SECA") taxes that were imposed on the wages paid. At that time, the amount of FICA taxes imposed on the wages paid to employees was higher than the amount of SECA taxes imposed with respect to a similarly-compensated independent contractor. That disparity actually was not as significant as alleged since an employer was entitled to deduct its share of FICA taxes, while no portion of the SECA tax was deductible. For all practical purposes, the FICA tax/SECA tax disparity was eliminated by subsequent legislation.

TREASURY "SHALL SET FORTH RULES"

Proposed Subtitle C of Title VII of the HSA says, "The Secretary shall prescribe regulations setting forth rules for determining whether an individual is an employee . . . " Section 7301(a). These three lines buried within the enormous HSA would

have an effect far beyond what most people realize. There are three points related to this provision that deserve special attention:

1. It is disingenuous to label Section 7301 as "anti-abuse regulations."

Section 7301, found in Title VII, Subtitle C, is labeled, "Anti-Abuse Regulations Relating To Employment Status." However, this title is entirely disingenuous. If the goal truly is to prevent independent contractor abuses, far less radical action is required.

As you know, under current law, decisions about who is and who is not an independent contractor are based on the application of 20 common law factors. See Rev. Rul. 87-41, 1987-1 C.B. 296. As mentioned earlier, these factors all revolve around the extent to which an employer maintains control over his or her worker.[1] In general, the more control an employer exercises over the worker, especially control over the details and means by which the service is performed, the more likely that worker is to be considered an employee rather than an independent contractor. See Section 31.3121(d)-1 (c)(2) of the regulations.

Over the years, this principle has been "fleshed out" by private letter rulings, revenue rulings, case law, internal IRS guidance documents called coordinated issue papers, the Internal Revenue Manual, articles, numerous IRS characterization decisions and a limited number of related regulations. This "coral reef" of law, which has built up over several decades, provides the IRS with substantial certainty in pursing those who would abuse the system.

Mr. Chairman, this is a very important point. The reason this provision is in the HSA is because of the fear that some companies will attempt to "game" the system by characterizing workers as independent contractors to avoid the potentially significant new costs of health care reform. *However, we contend that the body of law that has developed around this issue over several decades provides the IRS with ample tools to pursue those who would manipulate worker classification to avoid future costs of health care.*

Nevertheless, if you believe, as some do, that additional steps beyond the law referenced above are needed to reduce abuses, an array of *true* anti-abuse provisions are available for the Committee's consideration. For example, improvements may be possible in the area of information reporting. We would welcome an opportunity to work with you in developing precisely targeted anti-abuse provisions as there are many ways to attack abusers without completely restructuring the entire independent contractor regime. Please do not throw out the baby with the bathwater.

2. Allowing the Treasury Department to write regulations will likely result in dramatic limitations on the use of the independent contractor designation

In truth, this proposed section represents a major policy shift that should not be disguised as a minor anti-abuse provision. If the Treasury Department is given the authority to redefine the independent contractor designation, the result is entirely predictable. At worst, we believe Treasury will define independent contractors out of existence. At best, it will restrict the definition far beyond what is necessary to limit abuses.

Congress imposed a *statutory prohibition* against Treasury promulgating regulations affecting this area because of well-documented concerns about the IRS's pursuit of independent contractors in the past. That provision, Section 530(d) of the Revenue Act of 1978, was adopted after "taxpayer complaints" when the IRS increased its tax enforcement in the 1960's and 1970's and a "substantial" number of independent contractors were reclassified as employees, according to the testimony of Evelyn A. Petschek of the Department of Treasury before the House Subcommittee on Select Revenue Measures in 1992. Former IRS Commissioner Donald Alexander came before that same Subcommittee in 1979 and confessed to ". . . too effective and hard-nosed" activities by the IRS regarding audits against independent contractors. Others would use stronger terms to characterize the IRS's activities in this area. If the IRS is allowed to redefine independent contractors, then the ability of businesses and individuals to *legitimately* use the designation will be drastically limited.

Let me give you one recent example of the IRS's hostility toward independent contractors. The Service recently released a draft of an internal guidance circular related to independent contractors in the securities industry. Remarkably, the IRS circular said that an employer who takes steps to ensure that a worker acts within state and federal law is increasing the likelihood that that worker will be characterized as an employee. In other words, if you want to be sure your worker is not clas-

[1] In this written testimony, the word "worker" will be used neutrally to describe a body of people that includes both employees and independent contractors.

sified as an independent contractor, do not take steps to ensure that he or she complies with applicable law. Mr. Chairman, every one of the tax professionals using our services must comply with a myriad of federal and state laws—and we certainly take steps to ensure they comply—but that hardly makes them employees! In fact, since all marketers of financial products in the securities industry are subject to federal and state law, the effect of this circular would have been to outlaw, or at least significantly narrow, the use of independent contractors for companies like ours. Fortunately, common sense prevailed and this draft has been withdrawn for revisions and, for that, we are very grateful to the IRS.

After hearing the constant IRS criticism of independent contractors for three decades, one might reach the conclusion that this is a disfavored designation. Nothing could be further from the truth. In testimony before the Subcommittee on Select Revenue Measures, the IRS has said that the law dictates no preference over "employees" or "independent contractors." They are simply two legitimate categories for the classification of workers. The independent contractor designation performs a legitimate function in a modern society where companies and individuals engage in a continuous stream of short term relationships for specified tasks. The alternative is a society where everyone providing a service to a company—from the temporary secretary to the painter to the data programmer to the tax preparer or investment advisor—must be treated as an employee.

In all fairness, we should mention the proposed statutory language of this section requires that the Department of Treasury regulations give "significant weight" to the existing common law related to independent contractor designations. We appreciate this language, which is certainly an improvement over the first draft of the HSA that said the regulations would override all existing rules, including existing statutory provisions. Nonetheless, the "significant weight" requirement gives us little comfort. We believe the "significant weight" provision would provide little impediment to Treasury as it drafts a constricted rule in the independent contractor area.

3. In practical terms. we believe this proposed section is the equivalent of a substantial new tax on many legitimate users of the independent contractor designation

The impact of this change in policy will be significant. The Small Business Administration ("SBA") estimates that almost one-third of all companies in the U.S. rely to some degree on independent contractors. The SBA estimates that there are 5 million independent contractors in America. *Mr. Chairman. tightening the definition of independent contractor is the legislative equivalent of a substantial new tax on many honest, law-abiding companies.*

Let me also point out that the impact of this proposed section goes far beyond health care because of the critical precedent that it would set. It would affect the social security and unemployment payments we must make. It would affect the taxes we would pay and the taxes we withhold from our "newly classified" employees. It would affect the fringe benefits we provide our workers, certain wage and hour laws, and workers' compensation. It has critically important implications on matters of malpractice and tort liability.

The proposed changes to the worker classification rules would discourage businesses from entering into arrangements with independent contractors. By permitting the Treasury Department to modify the rules for distinguishing employees from independent contractors, the HSA would impose a looming uncertainty over all independent contractor arrangements.

Businesses would not know when the rules would be changed, and they would not know what the new rules would provide. Businesses would likely react by reducing their reliance on independent contractors. Such a consequence would be damaging to the nation's economy, in addition to being demoralizing to the many individuals who have been victims of large corporate "downsizings" and have vowed to remain independent in order to increase control over their economic destiny.

The economic effect on my company, H.D. Vest, will be enormous. Had our independent contractors been classified as employees in fiscal year 1993, the cost to our company in additional taxes, workers' compensation and health insurance costs would be $12.3 million. $12.3 million represents a staggering 2% of our fiscal 1993 revenues of $46 million. In addition, *$12.3 million is more than four times our net income of $2.934 million in fiscal 1993.* I do not need to spell out to you the impact of a new tax of 2% on our company and other similarly situated companies in our industry.

Comparing this to a new tax is entirely appropriate. Imagine that you are a small company legitimately complying with the current independent contractor law. Imagine that as result of a statutory change in the HSA, the definition of independent contractor is narrowed and no longer applies to your workers. For the purposes of

this example, assume the impact on a single worker earning $25,000 per year. At the very least:

- You now must make a social security tax payment of about $1,550.
- You now must make a Medicare tax payment of $362.
- You now must make a federal unemployment tax payment of $434.
- You now must provide health care coverage at a cost we estimate at about $3,000.

Together those costs alone—and there are others not included here—total more than $5,000 for a worker with an income of $25,000! Now in technical terms, this might not truly constitute a new 20% tax on that worker. But in the business world, what you call it does not matter. What matters is that the cost of doing business for that single worker just increased. And that relatively insignificant $5,000 increased cost becomes extremely significant when it is multiplied by the 4,200 tax professionals who use our services.

THE SAFE HARBOR PROVISIONS

Because of time and space constraints, we have chosen to focus our attention on the HSA's grant of authority to write regulations. However, we would be remiss if we did not at least mention the unfortunate effect of passage of Section 7303 of the Act as well. Section 7303 revamps safe harbor provisions, which have been available to taxpayers for 15 years, in a manner that is inconsistent with the purposes of the HSA.

These safe harbor provisions are without question the strongest weapon available to taxpayers for defending against IRS challenges to their treatment of workers as independent contractors. In cases where relief under the safe harbor is available, the dispute can generally be resolved expeditiously and at a relatively small cost to the taxpayer.

The HSA would repeal Section 530 and replace it with a new safe harbor provision that would be more difficult to satisfy and provide less protection. Many businesses now protected under Section 530 would not be eligible for the new safe harbor provision proposed in the HSA.

There is no justification for such a wholesale change to Section 530. According to the Joint Committee on Taxation, the purpose of a revision of Section 530 is to prevent businesses from converting existing employees to independent contractor status to avoid potential new health care obligations. Yet Section 530 provides absolutely no protection with respect to any worker who has been "treated . . . as an employee for any period." Section 530(a)(1)(A). *In other words, the proposed changes to this safe harbor will have no effect on a company that attempts to convert existing employees to independent contractor status to avoid the additional new costs of health care.* Simply put, the revisions to Section 530 miss their mark, and as such, reduce the protections available to taxpayers for no identified purpose.

CONCLUSION

We would welcome an opportunity to work with you and your staff. If you truly want to eliminate abuses, replace the dangerous, unpredictable language of Subtitle C of Title VII with precise anti-abuse provisions. We would be happy to work with you to identify the best approaches. Above all, please do not grant Treasury unfettered discretion to decide the fate of our company and so many others like it.

Attachment.

H.D. VEST FINANCIAL SERVICES,
Irving, TX, May 25, 1994.

Senator DANIEL PATRICK MOYNIHAN, *Chairman,*
Senate Finance Committee,
Washington, DC

Dear Mr. Chairman: Thank you again for the opportunity to testify before your Committee on May 3. As you recall, I testified on behalf of H.D. Vest Financial Services ("H.D. Vest") and the Independent Contractor Association of America ("ICAA") regarding proposed changes in employment status law in the Health Security Act ("HSA"). Our position is that the Treasury Department should not be given broad authority to draft regulations defining independent contractors and that any statutory changes should preserve the current worker classification regime.

At that hearing, you specifically asked for our reaction to the testimony of Dr. Myron Hulen, who spoke on the same panel for the American Tax Policy Institute

("ATPI"). In particular, you asked for comments about the new worker classification standard proposed by the ATPI. This letter represents the views of my company only on the Dr. Hulen/ATPI worker classification proposal; we have not commented on the other Hulen proposals regarding reporting/compliance and the safe harbor issue.

We have carefully reviewed the proposed new worker classification standard outlined in Dr. Hulen's testimony. He would replace the 20 common-law factor test currently used by the Internal Revenue Service ("IRS") with a new four factor test. Workers would be classified as independent contractors if they met any one of the following tests:

- They could suffer a loss or make a profit from the provision of services.
- They have a principal place of business other than the premises of the service recipient.
- They generally make services available to the public as self-employed individuals.
- They have worked for three or more service-recipients on a non-exclusive basis during the current or previous year.

In developing this model, ATPI has conducted a review of 321 IRS determination letters. ATPI has concluded that this shorter, simpler, less subjective approach is consistent with current employment status law in 93% of the cases.

H.D. Vest supports the ATPI model. Most importantly, as I mentioned during the hearing, it reduces the subjectivity inherent in the current system. While it is well established that existing law is based on 20 common law factors, there is no system of *weighing* these factors. A factor given great weight in one case may have no significance in another. This model removes the weighing ambiguity by establishing a bright line test—if you meet any of these four criteria, you are an independent contractor.

Moving from a 20 part test to a 4 part test also will simplify the existing system. Evaluating a worker by considering 20 possible factors can be confusing and difficult. Analyzing that same worker by applying these four clear factors would be much simpler. This is particularly important for small businesses that do not have the resources to retain legal assistance to analyze each specific situation.

This model works because the ATPI has selected factors appropriately consistent with employment classification law. The appropriateness of these four factors is borne out by the 93% consistency rate with IRS decisions. During hearings related to the HSA, including the May 3 hearing, the IRS has said it does not intend to significantly change existing law. This model maintains the contours of existing law while increasing the certainty necessary to pursue abusers.

We are particularly pleased that this model would eliminate the need for Section 7301 of the HSA, which would grant broad authority to the IRS to write regulations. These four provisions are simple enough to be part of a statutory definition. Indeed, as I testified and Congress affirmed with the 1978 amendment prohibiting the IRS from issuing independent contractor regulations, the worker classification issue is too important to leave to the IRS' regulatory discretion based upon 20 confusing common law factors. As Dr. Hulen said in response to your questions at the hearing, the IRS has "an institutional bias" in this area since in "99%" of the cases they classify workers as employees, not independent contractors. The Congress instead should set the worker classification standards in statute and Dr. Hulen's four factors offer the best, most clear-cut statutory approach we have seen.

We believe this language could help resolve the controversy over independent contractor status that has existed in this country for decades. We urge you to consider including the ATPI's proposed new worker classification standard, in its entirety, as part of the Committee's legislative proposal.

Again, thank you for allowing us to be part of this important process. We and our Washington, D.C. counsel, Bruce Heiman, are available to work with you or your staff as needed.

PREPARED STATEMENT OF SENATOR DAVID L. BOREN

Mr. Chairman, I appreciate the opportunity we have today to hear the position of the Administration and of other witnesses concerning the proposal in the Administration's health care package that would grant the Internal Revenue Service broad new powers to reclassify independent contractors as employees for health care and other tax purposes. This is an issue of great importance, especially for small businesses. The question of the proper classification has been one that this Committee

has discussed for many years, even before our heightened awareness of the issue in the context of health care reform.

I understand that, in general, the classification standards currently used are the common law rules defining who is an "employee." Although in particular cases the application of the common law rules are not as clearcut as one would like, they nonetheless provide a generally accepted set of principles that taxpayers have relied on for many years. In fact, many businesses have legitimately structured their service provider relationships on the basis of the common law principles.

I would be greatly troubled if the IRS were to be granted unfettered discretion to rewrite the definition of "employee." The effect of this broad power would likely be the disruption of legitimate practices and existing relationships. I would also be disturbed if legislation that this committee adopts contained language or definitions that upset these long-standing business practices. For example, the newspaper industry uses a decades-old distribution system that is based on the legitimate and appropriate use of independent contractors. We must be careful not to change the tax law in a way that will penalize this important industry and others like it for using well-established patterns of business organization.

I am sympathetic to the argument that the question of who is an employee or an independent contractor may be a difficult call in some circumstances. But allowing the IRS to exercise nearly complete discretion in all cases is not the right answer. Such a response would force businesses to restructure their operations at considerable cost with reduced productivity. Instead, the IRS could be given the ability to deal with abusive situations where a business artificially rearranges service relationships to avoid mandates or to qualify for subsidies, if such provisions are part of the health care reform package. I hope that I can work with the Chairman and the other members of the Committee to fashion a narrowly-targeted anti-abuse rule for these circumstances.

PREPARED STATEMENT OF ROBERT A. GEORGINE

Mr. Chairman and Members of the Committee: I very much appreciate the opportunity to testify today on behalf of the Building and Construction Trades Department, AFL-CIO, the fifteen International Unions affiliated with the Department and our four million members across the country. A subject of this hearing, independent contracting, is a matter of utmost importance to us, to every construction worker in the United States and to honest, law abiding contractors.

My testimony will focus on those provisions of the Health Security Bill intended to modify current rules relating to the classification of workers as employees or independent contractors. These modifications, once adopted, would facilitate the Internal Revenue Service's efforts to challenge current, wide-spread abuses of the classification rules.

Misclassification of construction workers as independent or bogus contractors poses an unparalleled threat to the construction industry. It undermines fair competition in the industry and it saps the collective strength of organized workers. Let me be very clear about our definition of bogus contracting. Bogus contracting is the practice of forcing workers to perform their normal jobs, not as employees paid by the hour with wages and benefits, but, rather, as independent contractors paid on a different basis, usually a lump sum and lower than the equivalent of their wages, denied benefits, and with no employment taxes paid on their behalf. These workers are not contractors. They do not hold themselves out to be contractors. They have no company, no bookkeeper, no equipment and they surely have no idea about the responsibilities of being self-employed.In short, they have been duped. Not only do they lose their benefits of health insurance, retirement and vacation, they are left to contribute on their own to social security, unemployment insurance and workers' compensation payments.

Why do dishonest contractors take the risk of foisting this fraud upon their workers and the government? Unfortunately, the monetary payoffs are great, the chance of being caught is slim and the penalties, if discovered, are almost inconsequential. By misclassifying their workers, unscrupulous construction contractors have been able, under current law, to evade their obligations to pay employment taxes and worker compensation premiums. They have also unlawfully denied coverage to workers and their families under pension, health and other employee benefit plans.

A construction contractor using misclassification can greatly reduce its labor cost, which account for nearly 50% of the cost of the average construction contract. These ill-gotten savings can amount to a significant percentage of total labor costs thereby giving a contractor an almost insurmountable advantage over honest bidders.

Why do construction workers allow themselves to be misclassified? Sadly, they either have no choice or they misunderstand the obligations and penalties associated with working as bogus contractors. Workers are often told if they want to work they have to do so as a bogus contractor. With the industry's high unemployment, an out of work employee, has a hard time turning down a chance to put bread on the table. In addition, the worker who agrees to be a bogus contractor, usually, doesn't understand all that it implies. The requirements associated with self-employment, of paying estimated quarterly taxes in advance, of acquiring a federal employer identification number, of establishing an employer's social security, unemployment insurance and workers' compensation accounts are not routine to a regular construction worker. Acquiring a health insurance policy through a private carrier, at an individual rate, is another responsibility alien to one who has been the beneficiary of group insurance through a union's health and welfare fund. Without the intent to do wrong, and surely without any awareness of potential consequence, the construction worker turned bogus contractor, continues the fraud begun by the dishonest contractor.

Bogus contracting has severely effected the industry. Honest contractors are placed at a tremendously unfair advantage by contractors who perpetrate this practice. They find it impossible to compete against a contractor who has reduced its costs to perform work, through misclassification, by anywhere from 25 to 40 percent of a total bid. As a result, unable to win contract awards, honest, responsible contractors who invest in apprenticeship, employee benefits and safety and health programs, lose their businesses and our members lose their jobs.

In fact, all of society is victimized by bogus contracting. The loss of tax revenue is estimated to be in the millions at the state level and in the billions at the federal level. According to the Internal Revenue Service, uncollected taxes from self-employed individuals (which include independent contractors) totaled $20.3 billion dollars in 1992. This invidious practice not only erodes the tax base, it increases the number of dependents needing government sponsored services. Hospitals and income support programs will likely be needed by bogus contractors and their families in lieu of those that the employers should have provided.

And, the practice is growing. Between 1970 and 1991, the number of self-employed workers in construction grew from roughly six hundred and eighty thousand to nearly one and a half million, according to the United States Bureau of Labor Statistics. These numbers are consistent with the estimates of the Internal Revenue Service. The IRS reports that more than 80 percent of construction contractors have no employees. It is now believed that independent contractors constitute twenty to twenty-five percent of the construction work force. While some of those are legitimate, that is, they are independent contractors who want to be in business for themselves, most are presumed to be in this status illegally and against their will.

With the Health Security Bill requiring employers to cover at least 80% of employees' health care costs, a provision, I might add, that we endorse unequivocally, the need to clearly define who are "employees" becomes ever more critical. Passage of the Bill, without a provision to prevent abuses of the classification system, would create even greater financial incentives for unscrupulous employers. Left unregulated, dishonest contractors will avoid payments for health care by misclassifying their construction workers. As a result, those workers left without employer paid health coverage would have to pay the full cost out of their pocket or would have to join the ranks of the uninsured for whom all taxpayers would be responsible.

The Building and Construction Trades Department has made the fight against worker misclassification one of our top priorities. We support the classification provisions in the Bill as an important first step. In fact, we believe that it is a step which should be taken whether or not health care reform is enacted. Unless something is done, honest construction contractors will continue to suffer unfair competition from those who are prepared to cheat, and construction workers and their families will continue to be denied protections and benefits to which they are legally entitled.

Prior efforts by the Department to eliminate classification abuses have encountered multiple barriers. The following summarizes those efforts and describes how the provisions of the Health Security Bill would help remove at least some of them.

I would also urge that the legislative history of this Bill incorporate a specific directive to the IRS to concentrate its efforts on remedying classification abuses in the construction industry where violations of the law are clearly most prevalent.

I. WORKER MISCLASSIFICATION IN THE CONSTRUCTION INDUSTRY

As discussed earlier, it is beyond question that worker misclassification abuses are rampant in the construction industry. The House Committee on Government

Operations has so concluded based on extensive testimony.[1] At least six state legislatures have recognized that misclassification is a particularly severe problem in the construction industry and have enacted targeted legislation authorizing losing bidders on construction contracts to sue for damages if the winning bidders are found to have misclassified their workers.[2] Similar legislation is pending in other states.[3]

Classification abuses in the construction industry are not inadvertent or the result of good faith mistakes. The misclassification of construction workers typically results from blatant and willful efforts by contractors to evade the law. The Department and its affiliates every day encounter cases where construction contractors claim to have *no employees*. The contractors may have scores of workers, who are required to report to work at set times and are supervised by foremen, but they are all treated as independent contractors.

These workers are clearly employees under any reading of applicable law, but the contractors simply choose to ignore the law and instead play the audit lottery. All too frequently this strategy has been successful.

The IRS recognizes the abuses that are occurring but feels itself constrained in attacking the problem by current law restrictions, as well as budgetary considerations. In too many cases, IRS agents feel there is no point going after a contractor who misclassifies employees, because the contractor will be able to hide behind the alleged vagueness of current law or can qualify for the safe harbors of Section 530, which I will discuss in a moment.

The predominant test today for distinguishing employees from independent contractors is the "common-law" test, which examines the degree to which the employer has the right to control and direct the individual performing the work, 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 to be accomplished. In applying the common law test, the IRS normally will examine 20 factors to determine whether sufficient control and direction exist in the particular case to establish an employer-employee relationship. See Rev. Rul. 87-41, 1987-1 C.B. 296, 298-300.

In order to curb what was perceived as overzealous reclassification of workers by IRS agents, Congress created an important exception to the common law test when it enacted Section 530 of the Revenue Act of 1978. Under Section 530, employers who treat their workers as independent contractors are provided "safe-harbors" precluding the IRS from reclassifying the workers as employees under certain circumstances. The Section 530 safe harbors apply where (1) the employer relies on judicial precedent or an IRS ruling; (2) the employer relies on a prior audit by the IRS which did not result in its workers being reclassified, even if the audit did not examine the employer's treatment of its workers as employees or independent contractors; or (3) the classification of such workers as independent contractors is a recognized industry practice.

Section 530 also bars the IRS from issuing rulings or regulations that would provide general guidance on the proper treatment of workers as independent contractors or employees.

In November of 1990, the House Government Operations Committee issued a report estimating that the misclassification of workers under the federal tax laws results in annual revenue losses in the billions of dollars.[4] This 1990 Report concluded that the current 20-factor common law test is extremely subjective and often inconsistently applied. In addition, the Section 530 prior audit safe harbor creates substantial inequities among similarly situated employers.

The Subcommittee on Employment and Housing of the House Committee on Government Operations held a hearing on the problem of worker misclassification in April of 1991, focusing in particular on the construction industry. Witnesses at the

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[1] House Comm. on Gov't. Operations, Contractor Games: Misclassifying Employees as Independent Contractors, H.R. Rep. No. 1053, 102d Cong., 2d Sess. at 7 (Oct. 16, 1992) (the construction industry "appears to be the industry most widely affected" by misclassification.)

[2] *See e.g.*, Exploiting Workers by Misclassifying Them as Independent Contractors: Hearing Before the Comm. on Gov't Operations, 102d Cong., 1st Sess. 76 (April 23, 1991).

[3] *See id.*

[4] House Comm. on Gov't Operations, Tax Administration Problems Involving Independent Contractors, H.R. Rep. 101-979, 101st Cong., 2d Sess. (1990) (the "1990 Committee Report"). The findings incorporated in the 1990 Committee Report were based in part on three Government Accounting Office ("GAO") studies that had been commissioned by the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Government Operations Committee, following that Subcommittee's hearings on the issue on May 16, 1989. See GAO Report, GAO/GGD 89-110, *Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected;* GAO Report, GAO/GGD 89-63, *Tax Administration: State and Local Compliance with IRS Information Reporting Requirements;* GAO Report, GAO/GGD 89-107, *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers.*

hearing, including representatives of labor and industry, testified that many construction contractors deliberately misclassify workers. Witnesses from the IRS stated that, while the IRS was concerned about deliberate misclassification and had increased its employment tax audits, the Section 530 safe harbors have "hamstrung" tax administration in this area.

On June 8, 1993, the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Government Operations held another hearing on worker misclassification. An IRS official testified that, in one district, the IRS learned that employers in the residential construction industry were misclassifying some 64% of their workers as independent contractors and that in 20% of the cases, the employers had failed even to file Forms 1099 for their workers. In another district, the IRS found that general contractors had one of the highest classification error rates.

There is clearly a problem here, which the IRS has not been able to correct given current law restrictions. The provisions of the Health Security Bill represent a reasonable legislative response.

II. PROPOSED LEGISLATIVE SOLUTION

Sections 7301 through 7303 of the Health Security Bill would repeal Section 530 and replace it with a modified version designed to protect taxpayers against retroactive reclassifications while at the same time permitting the IRS to enforce the law. Importantly, the IRS would be given the authority to issue regulations defining the term "employee."

The scope of the "prior audit" and "industry practice" safe harbors would be restricted. A prior audit would permit an employer to treat workers as independent contractors only if the audit actually considered the employment status of those workers or workers holding substantially similar positions. Moreover, the prior audit safe harbor would not apply for periods after the IRS issues an inconsistent ruling, regulation or other authority or notifies the employer that the workers should be treated as employees.

The "industry practice" safe harbor would cease to apply once the IRS regulations defining "employee" are issued or if inconsistent rulings or other authorities are published by the IRS or if the IRS notifies the employer that the workers should be treated as employees.

The IRS would be permitted under the Bill to issue regulations that are to give significant weight to the common-law rules, but which presumably may assign specific weight to particular factors in particular cases.

This approach should eliminate many of the obstacles the IRS has identified as the reasons why current enforcement efforts have been unsuccessful. Therefore, the Department supports these proposed changes.

At the same time, the Department believes that these changes will be effective to remedy the wide-spread abuses in the construction industry only if the IRS exercises its regulation authority so as to provide bright line objective standards for determining when a construction worker is an employee or an independent contractor. In this way, noncomplying contractors will find it more difficult to claim confusion as a defense if caught—and thus it will be easier for the IRS to impose penalties to deter abuses.

The Building and Construction Trades Department has supported targeted legislation to provide explicit rules for defining when construction workers are employees. The Department at that time suggested that an individual construction worker should be treated as an independent contractor only if all of the following conditions are met:

1. The individual must hold himself or herself out to the public on a regular and consistent basis as a construction contractor, by advertising to the public as a contractor, by submitting competitive bids on construction projects, or by posting performance bonds in connection with the provision of construction services.
2. The payment to the individual must be based on a price set at the beginning of a job, or on commission (rather than by the hour, day, week, month, or some other measure based on the amount of time worked rather than progress made on the job).
3. He or she must have the potential to realize a profit on a job and must be exposed to the risk of suffering a net loss (other than the risk of profit or loss ordinarily assumed by employees, such as the risk that the employer will be financially unable to pay).
4. The individual must have the right to hire his or her own employees to perform the job, and cannot be obligated to render the services personally.
5. The individual cannot be an independent contractor if he or she was hired through a labor union hiring hall or dispatch system to perform the services.

6. Finally, the individual must not be an employee under the usual common law test.

We believe that similar rules should be adopted by the IRS in any classification regulations issued pursuant to the Health Security Bill. I urge that the legislative history clearly reflect the importance Congress places on remedying abuses in the construction industry, including the legislative intent that specific guidelines along the lines suggested be adopted.

The Committee is to be commended for taking up this vitally important legislation. Compelling considerations of fairness to workers and their families require that prompt action be taken.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Mr. Chairman: I just want to voice my strong concerns regarding the administration's independent contractor proposal. In my opinion, if we accept this proposal as it is, we as members of congress, will be abdicating our responsibilities. We will be handing over way too much authority to the treasury department.

We all spend too much time around here trying to fix problems that have been caused by giving the administration too much power in defining the law. Whether it's problems with in-kind payments to farmers, hedging transactions, fuel tax collections, association fees for farmers or various retroactive applications, we are constantly faced with administration-made decisions that have negatively impacted our constituents.

In this proposal, the administration is basically asking us to give them the authority to define what an "employee" is and deal with the wide-ranging consequences later. I'm sure this is a well-intentioned proposal. But, this isn't only a bad way of legislating, it's the wrong way. And it's a dangerous way. Those of us that have been around here for a while, should have learned from our mistakes by now.

It seems to me that the only reasonable way to proceed on this issue is to either look at increasing the penalties for those that improperly reclassify employees, or if treasury is going to come up with an employee definition, I want to see that definition before I vote on it.

As the ranking member on the IRS oversight subcommittee, I have some added responsibility in protecting taxpayers' rights. I see a great potential for possible taxpayer abuse in this proposal. And, I believe that it's imprudent to radically change the law in this controversial area under the auspices of healthcare reform, which is already controversial enough.

Mr. Chairman, I just think it's a big mistake to vote for something we haven't even seen. We've done that too much in the past, and I predict that if we do it this time, we'll be back here later trying to fix it. So, I hope that reason will prevail in this case and the proposal will either be dropped or substantially modified.

Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Good morning, Mr. Chairman, and thank you for holding this hearing today on these relatively arcane but very important subjects.

The issue of whether a worker is an employee or an independent contractor has been a difficult one for many years, both for employers and for the Internal Revenue Service. Why? Because there are currently financial incentives for employers to misclassify workers as independent contractors when, in fact, they are employees. Now, the prospect of comprehensive health care reform legislation makes the stakes even higher. Under an employer mandate or a subsidy system that is based on the number of employees, a company may have an additional incentive to treat workers as independent contractors rather than employees, in order to avoid paying health care insurance premiums or to receive subsidies. Thus, the President's health care plan contains some provisions that will change the long-standing rules in this area.

I am the first to admit that there are abuses of the current rules by employers. And, I support the IRS in cracking down in cases where employers are blatantly avoiding paying taxes by misclassifying their workers. However, I am also concerned about the potential for abuse on the part of the IRS. I have had many constituents come to me for help in cases where the IRS has, in my view, improperly assessed tax on employers for treating workers as independent contractors.

I am concerned about the changes proposed by the administration and many of my constituents who are aware of the proposal are also concerned. Section 7301 of the bill gives the IRS the authority to define what an employee is. At the same time, the bill throws out the provision that has been in the law since 1978 that prohibits the IRS from issuing regulations on employment status. This prohibition was created and maintained since 1978 because of the widely held belief that the IRS should not have the authority to unilaterally set employment classification standards. Are we ready to say that these earlier concerns about giving the IRS the authority to set the rules were foolish? I have some serious concerns that this one-sided authority will leave taxpayers vulnerable to abuse.

Again, Mr. Chairman, I thank you for holding this hearing. I look forward to the testimony of the witnesses.

PREPARED STATEMENT OF MYRON HULEN

THE NATURE OF THE PROBLEM

For over twenty years independent service workers have been associated with tax compliance and administration problems. The problems include a tendency to understate income, overstate deductions, and a failure of employers to pay employment taxes by misclassifying employees as independent contractors. In addition, the misclassification of employees denies those workers rights and benefits provided under social legislation passed by congress and state legislatures thereby frustrating the intent of these laws.

The Small Business Administration (SBA) and the Government Accounting Office (GAO) estimate that there are about 5,000,000 independent service workers in the economy.[1] These workers amount to about one-third of Schedule C filers.[2] While there no tax gap estimates for independent service workers specifically, there are for Schedule C providers. The tax gap attributable to Schedule C filers for 1992 is $20.3 billion from understated income and $8.1 billion dollars from overstated deductions.[3] The revenue loss from employment and income taxes that are not withheld and paid because workers are erroneously classified as independent contractors is estimated to be another $2 billion for 1992.[4]

The amounts involved are large and the problems are not new and have been subject to extensive prior study and debate. We reviewed past recommendations, congressional committee testimony, and other available sources to determine the issues that needed to be addressed and past proposed solutions. We searched for commonalities as one means of determining the appropriate solutions. The results were combined with our own research and thoughts in arriving at the suggested solutions outlined below. We have divided the discussion into two areas: information reporting and compliance problems; and worker classification.

RECOMMENDATIONS CONCERNING INFORMATION REPORTING AND COMPLIANCE

The information return reporting system is the tool used to insure the full reporting of income by independent service workers. Because large amounts of income are not being reported, the system needs to be strengthened. The proposed changes generally involve expansion of the reporting requirements and better utilization of the data collected by the IRS. An alternative proposal would require the withholding of tax from payments to service providers. Each proposal should be considered in the context of its overall cost and compared to the increased compliance it is likely to achieve. The problem is that there is virtually no data available on the employer cost of reporting or IRS cost of processing and utilizing the information. It is fair to assume, however, that the costs of an expanded reporting system will be less than that of a withholding and deposit system.

There are some data on the effectiveness of the current reporting system. The IRS found that the voluntary reporting percentage of wages which had been subject to

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[1] See testimony of the Office of Chief Counsel for Advocacy of the SBA, before the Subcommittee on Export, Tax Policy and Special Problems of the Committee of Small Business, July 30, 1991. Lexis Doc. 91-6808.

[2] IRS. Statistics of Income, Summer 1992. Table 10.

[3] IRS. "Income Tax Compliance Research, Gross Tax Gap Estimates and Projections for 1973–1992," Publication 7285, March 1988 and Publication 1415, Income Tax Compliance Research, Supporting Appendices to Publication 7285, July 1988 at Table A-54.

[4] IRS, "Strategic Initiative on Withholding Compliance. (SVC-1), Misclassified Employees." September 1989.

withholding was 99.5 percent.[5] IRS estimates of the voluntary reporting percentage of income which had been reported on Form 1099, range from 97 percent to 77 percent and for income which should have been reported on Form 1099 but had not, range from 83 percent to 28 percent.[6]

Discussed below—proposals that have been gleaned from several sources, including H.R. 5011,[7] the General Accounting Office,[8] the Joint Committee on Taxation,[9] and the Committee on Government Operations.[10]

Increase the Penalty on Payors for Failure to File Information Returns

Under current law, payors face a $50 penalty for failure to file a required Form 1099-Misc.[11] Many view this penalty as inadequate and propose that a higher penalty be assessed against the amount of service payment that would be required to be reported on a Form 1099-Misc.[12]

Opponents of the proposal point out that the penalty for failure to file has increased over the years from $1 to $50; however, opponents note, there is no overwhelming evidence that increased penalties have led to increased compliance.

Recommendation Increase the penalty imposed on a service recipient for failure to file an information return. Establish the penalty rate at 100 percent of the employer's FICA rate plus 100 percent of the FUTA rate, after reduction for state credits. For 1993, the penalty would be approximately 8.75 percent. Waive the penalty in the case of de minimis nonfiling and clerical errors that do not in the aggregate exceed 3 percent of the total payments for the year.

Increase the Penalty on Service Providers for Failure to Provide a Correct TIN

Under current law, the penalty imposed on service providers for failure to supply a correct taxpayer identification number (TIN) or other information is only $50.[13] To encourage compliance by service providers, the penalty should be increased to a more significant level.

Recommendation Increase the penalty imposed on service providers for failure to provide a correct TIN. Establish the penalty rate at a level equivalent to the self-employment tax rate (currently 15.3 percent[14]) and impose it on the amount of compensation that would be required to be shown on a Form 1099-Misc., with a minimum penalty of $50. No penalty would apply if the amount of compensation to the service provider falls below the threshold level for filing a Form 1099-Misc.

Modify the Reporting Threshold for Payors

Many have suggested that the threshold for filing a Form 1099-Misc be lowered from $600 to $100 as a means of bringing more independent contractors into the

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[5] IRS, "Income Tax Compliance Research, Gross Tax Gap Estimates and Projections for 1973–1992," Publication 7285. March 1988. Table 1–2.

[6] These figures are cited by the GAO. The IRS made the following comment about them in a letter to the authors.

> Since these estimates are from separate studies on different types of compensation at different points in time, it may be misleading to use them in the manner the GAO does. Data from the IRS Strategic initiative on withholding Noncompliance (SVC-1) may be more relevant to the situation of misclassified employees. The tax year 1984 study Identified misclassified employees in employment tax examinations of 3331 employers and then determined the extent to which misclassified employees reported their compensation on individual tax returns. Those who received no Form 1099 reported 28.8 percent of their compensation and those who did receive a Form 1099 reported 77.2 percent of their compensation.

[7] H.R. 5011 was introduced on April 29, 1992 as a proposed amendment to the Internal Revenue Code to revise procedures applicable to the classification of workers, to increase information reporting by businesses, and to increase compliance by independent contractors.

[8] *Tax Administration: Approaches for improving independent Contractor Compliance* (GAO/GGD-92-108, July 23, 1992).

[9] Joint Committee on Taxation, *Present Law and Issues Relating to Misclassification of Employees and Independent Contractors for Federal Tax Purposes,* July 22, 1992 (hereinafter referred to as JCT).

[10] Thirty-Sixth Report by the Committee on Government Operations, "Improving the Administration and Enforcement of Employment Taxes," November 2, 1992.

[11] I.R.C. Sec. 6721(a).

[12] An increased penalty is contained in H.R. 5011 and supported by GAO and the Committee on Government Operations.

[13] I.R.C. Sec. 6723.

[14] I.R.C. Sec. 1401.

system.[15] Because of the burden that would be placed on payors, various business groups are opposed to this proposal.[16]

Recommendation Retain the present $600 threshold for filing but add a statutory requirement that the threshold level be subjected to a sunset review date of two years. As part of the sunset review, Congress should consider information provided by Treasury as to benefits, costs, and the ability of the IRS to handle an increased number of Forms 1099-Misc if the threshold is lowered.

Require Information Reporting for Payments to Corporate Service Providers

Current law exempts a payor from information filing for payments made to a corporate service provider.[17] Under current law, service providers can incorporate and thereby avoid the receipt of a Form 1099-Misc, and service recipients can seek providers who are incorporated as a way of avoiding the necessity to file Forms 1099-Misc. To close what is perceived as a loophole, many suggest that Congress eliminate the corporate exemption.[18]

Opponents note that the added number of Forms 1099-Misc will increase the administrative burden to the IRS and add to the reporting burden imposed on service recipients. Difficulties also arise in distinguishing between service payments and other payments.[19] Opponents have recommended modifications of the provision, the most notable of which is that payors be exempted from filing Forms 1099-Misc for payments to large corporate payees (those with gross receipts in excess of $15 million).[20]

Recommendation Require information reporting for payments to corporate service providers. The Secretary of the Treasury should be given authority to grant exemptions to specific corporations or classes of corporations if the IRS finds that information reporting is unnecessary as to them.

Establish a TIN Validation System

Under this proposal, IRS would establish a Taxpayer Identification Number validation system whereby a payor could make a toll-flee telephone call to verify a TIN before any payment is made to a service provider.[21] If the TIN could not be verified, the payor would be required to with hold tax at the backup rate of 20 percent.[22]

The IRS has established a pilot program for TIN validation in its Martinsburg Computing Center.[23] A sample group of service recipients will be permitted to access the IRS data base and obtain a simple yes or no as to a computer match between the service provider's name and TIN.

Recommendation Require payors to verify the TIN of a service provider before making any payment, to withhold taxes for those whose TIN cannot be verified, and to retain proof of verification.

Require Written Notification to Payees Who Are Treated as Independent Contractors

It has been proposed that, where a payee has been treated by a payor as an independent contractor, that the IRS provide both with a form advising that (1) the payee is liable for self-employment taxes, (2) the payee has the right to request an

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[15] This proposal is included in H.R. 5011 and is supported by the GAO and the Joint Committee on Taxation.

[16] Opposing testimony and statements presented in the Hearing Record of Select Revenue Measures Subcommittee include the Small Business Legislative Council (p. 148), Coalition of Independent Contractors (p. 158). Nurse Brokers and Contractors of America (p. 177). American Trucking Associations (p. 191), Black Data Processing Associates (p. 281). American Movers Conference and Household Goods Carriers' Bureau (p. 343). and Associated Builders and Contractors (p.357).

[17] Treas. Reg. Sec. 1.6041-3. To take advantage of the exemption, current rules require businesses to obtain a certificate from a payee that the independent contractor is a corporation.

[18] Information reporting for service payments to corporations is included in H.R. 5011 and is supported by GAO and the Committee on Government Operations. A similar provision was proposed by the House in H.R. 1960 (Revenue Reconciliation Act of 1993), but it was deleted in Conference.

[19] Opposition is expressed in the Hearing Record of Select Revenue Measures Subcommittee by the Small Business Legislative Council (p. 148), Coalition for Independent Contractors (p. 158). and American Trucking Associations (p. 191). Refer also to the Statement of the Tax Executives Institute, Inc. before the Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, House of Representatives, June 8, 1993.

[20] See "Comments on Service Industry Noncompliance Initiative," *The Tax Executive* (May-June, 1993). pp. 242–3.

[21] This proposal is part of H.R. 5011 and is supported by the GAO and the Committee on Government Operations.

[22] Under current enforcement procedures, IRS checks TINs on Forms 1099-Misc; however, it often takes more than 12 months to notify a payor of an invalid TIN.

[23] In *Tax Notes* (March 8, 1993), p. 1276, it was reported that the IRS plans to have a system in place this summer that will enable businesses to verify TINs on a voluntary basis.

IRS review of his/her classification as an independent contractor, (3) the payee will not be eligible for employee fringe benefits, (4) the payee may qualify for certain tax benefits such as a self-employed retirement plan, and (5) the payor may be required to file a Form 1099-Misc on all payments made to the payee; and requiring both payor and payee to sign and retain a copy of the form.[24]

Recommendation Require payors to provide payees treated as independent contractors with a standardized notification of their obligations and rights. Congress should specify the items to be explained in the notification and IRS should be directed to design a form to be used for these purposes. The form should be signed and retained by both parties as evidence of proper notification.

Compliance with the notification requirement should be as one of the conditions necessary to qualify for any safe harbor treatment under Section 530 or its successor.[25]

Provide an information-Reporter Line on income Tax Returns

Under this proposal, a separate line would be added to the income tax returns of payors on which total payments made to independent contractors would be reported.[26] Amounts reported on this separate line would not be part of the taxable income determination.[27]

Recommendation Require payors to report total Form 1099-Misc payments to independent contractors as an information item on a separate line of the income tax return. Failure to provide accurate information on this separate line would subject the payor to perjury penalties and the income tax return preparer to preparer penalties.

Establish an Education Program for Payors

This proposal is contained in H.R. 5011 and is advanced by the General Accounting Office and the Committee on Government Operations. All parties agree that if recommended changes are made, an education program will be crucial.

Recommendation Establish an intensive education program for payors regarding their responsibilities as to worker classification, wage reporting, information reporting requirements, and penalties. Payors should be provided with complete information regarding the tax consequences of treating workers as employees or as independent contractors.

Amnesty Program

Some have suggested a limited amnesty program under which $50 penalties for nonfiling of Forms 1099-Misc in prior years would be waived for businesses that comply with the new information reporting rules.[28]

Recommendation Do not establish an amnesty program at this time. An improved information reporting system should be sufficient to encourage compliance without the need for an amnesty program.

Tax withholding on Payments/to independent Contractors

This proposal is made by the General Accounting Office and suggested by the Joint Committee on Taxation. The proposal is opposed by the Committee on Government Operations and other groups representing the interests of small businesses.[29]

The Committee on Government Operations provides several arguments against the proposal: (1) payments to independent contractors often do not correspond to taxable income; (2) because of fluctuating levels of income, withholding at any one rate would create inequities; (3) to overcome inequities, it would be necessary to establish a system with multiple rates and/or exemptions; and (4) it is not clear that withholding offers a significant advantage over an improved system of information reporting.[30]

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[24] This proposal is part of H.R. 5011 and is suggested by the GAO and the Committee on Government Operations.

[25] Proposed amendments to Section 530 are discussed below.

[26] Businesses are required to file an annual report (Form 1096) which summarizes total payments reported on Forms 1099-Misc. The Form 1096 does not subject the business to a perjury penalty. The preparer penalties do not apply if a professional prepares the Form 1096.

[27] This proposal is part of H.R. 5011 and is supported by the GAO and the Committee on Government operations.

[28] An amnesty program is supported by the GAO and the Committee on Government Operations.

[29] Opposing testimony and statements in the Hearing Record of Select Revenue Measures Subcommittee include American Trucking Associations (p. 192) and American Movers Conference and Household Goods Carriers' Bureau (p. 343).

[30] 36th Report CGO, pp. 22–23.

Proponents point out that (1) individuals for which there is no withholding are tempted to become part of the underground economy and are difficult to identify and locate by the IRS; (2) withholding brings taxpayers and revenue into the system, (3) withholding decreases the need for IRS enforcement efforts.

Recommendation Do not adopt a withholding system for independent contractors. While such a system would be highly effective in bringing more independent contractors into the tax system, it would be overly complex. More empirical data are needed to determine if benefits would in fact exceed the costs of compliance and administration. Before such a drastic measure is adopted, proposals regarding an improved reporting system should be given a chance to work.

RECOMMENDATION CONCERNING A NEW WORKER CLASSIFICATION STANDARD

While the above compliance recommendations will improve voluntary compliance, they will not eliminate the need for correct classification of service providers as employees or independent contractors. The effects of classification extend well beyond the direct payroll and income tax compliance.consequences. Classification affects areas as diverse as retirement and welfare benefits, worker's compensation, and coverage under discrimination and fair labor standards laws. Many states also have rules that apply differently to employees and independent contractors. A clear standard of classification is needed in order to permit service recipients to classify workers with a minimum of effort and with the assurance that their classification will withstand examination.

It is generally acknowledged that the 20-factor test currently used by the IRS is not clear because the 20 factors are not present in every situation, some of the factors are not relevant to certain occupations, they vary in importance in different situations, and the weights given to them are subjective. Matters are further complicated because the 20 factor common law test must be applied by every entity or individual using a worker, regardless of size, sophistication, or the availability of competent advice on the application of the test.[31]

The need for simplified classification standards has been acknowledged for some time, and several agencies have made suggestions in this regard.[32] The fact that none of these simplified standards has been adopted seems to have stemmed from the fear that they would encourage a migration of workers from employee status to independent contractor status, further eroding the compliance rate. In our research, we reviewed the standards previously proposed and evaluated them on (1) their ability to provide classifications that—consistent with current IRS classifications; (2)their applicability to a reasonably large cross-section of the independent contractor population; and (3) the likelihood that their use would tend to encourage migration to independent contractor status.

Our major contribution to this analysis was our ability to perform the evaluation in an objective fashion thorough the use of a data base of IRS records and final classification results obtained from 321 IRS determination letters. We treated each proposed stands as a model, and we evaluated the results of applying that model against the results produced in the IRS determinations. We assessed whether the requirements of each of the models had been satisfied in the IRS determinations, and we then constructed a classification table comparing the IRS determinations with the results that would have been obtained under each of the models.

We found that the drafters of most of the models were so concerned with the potential migration of workers into independent contractor status that they tended to design requirements that were too strict. When the requirements were relaxed—that is, when fewer requirements were imposed for independent contractor classification—a number of the models provided results that were very consistent with IRS determinations.

Recommendation Adopt a new classification standard that is based on a dearly-defined subset of the current common law rules, that is easily understood by taxpayers, and that reflects a combination of the requirements of several of the models. Under this service providers would be excluded from the common law definition of "employee" if they met at least one of the following four tests:

1. they could suffer a loss or make a profit from the provision of services;
2. they have a principal place of business other than the premises of the service recipient;

[31] ABA, Hearing Record of Select Revenue Measures Subcommittee, p. 129.

[32] We reviewed simplified classification rules proposed by the Government Accounting Office, Small Business Administration, American Institute of Certified Public Accountants, National Federation of Independent Business, and several academic researchers.

3. they generally make services available to the public as self-employed individuals; or

4. they have worked for three or more service-recipients on a non-exclusive basis during the current or previous year.

Application of this model to the fact situations in the IRS determinations resulted in classification of 93 percent of the service providers in & manner consistent with the IRS determinations. This is not surprising, given the fact that each of the elements of the model requires a relationship the substance of which is consistent with status as an independent contractor.

In addition to meeting one of the four requirements of the model, the relationship would have to satisfy several other compliance-oriented requirements, such as the maintenance of books and records, the existence of a written agreement between service provider and service recipient, and an attestation that the necessary self employment and income taxes have been or will be paid that all required information returns either have been or will be filed.

If the service provider did not meet the new standard, or if the service recipient failed to satisfy the other compliance requirements, the classification would have to be made on the basis of the existing common law rules.

RECOMMENDATIONS RELATED TO THE SAFE HARBOR TEST OF SECTION 530

Under Section 530,[33] enacted as a temporary relief provision in 1978, the IRS may not reclassify service providers if the service recipient has a reasonable basis for treating the provider as an independent contractor. A reasonable basis is present if the service recipient relies on:

1. a judicial or administrative precedent,

2. a past IRS audit (any audit of any tax as long as the IRS did not make a finding that the worker was an employee); or

3. a long standing practice of a significant segment of the industry in which the worker was engaged.

Further, Section 530 contains a consistency clause that denies safe harbor protection to any employer who has treated an individual holding a substantially similar position as an employee at any time after 1977.

The recommendations for improvement in Section 530 that are presented below are based on the need to permit the IRS to apply the law fairly and consistently. However, they are also based on Congress' stated intention that Section 530 should be construed liberally in favor of the taxpayer.[34] Any revisions to Section 530 should reiterate that statement of Congressional intent so that it remains a clear objective.

Retrospective Rather Than Prospective Protection

The principal defect in Section 530 is that its safe harbor protection, once obtained, lasts forever. If a payor who has misclassified service providers qualifies for protection, the misclassification becomes permanent, resulting in loss of revenue to the government and unwarranted competitive advantage to the service recipient.

Recommendation Section 530 should be amended to provide only protection from retrospective reclassification. The IRS should be grant the authority to prospectively reclassify misclassified workers. However, because of the inherent subjectivity of the common law rules, the IRS should bear the burden of proving that the prior classification was incorrect and that prospective reclassification should occur.

The Prior Audit Rule

It has been suggested that the prior audit rule be restricted to employment tax audits of some specific variety.[35] Adoption of these proposals would complicate the law unnecessarily and would restrict the applicability of Section 530.

Recommendation The prior audit rule should be retain in its current form. This recommendation is justified because the IRS would, upon a proper showing of misclassification, be allowed to reclassify workers prospectively. Moreover, while IRS rulings would be permitted to terminate protection under the rule prospectively, the burden of proof for the necessity of reclassification would shift to the IRS. If a prior misclassification was not blatant enough to have attracted attention on a prior

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[33] Section 530. Revenue Act of 1978, P.L. 95-600.

[34] HR Report 95–1748, p. 633.

[35] For example, the AICPA proposes that prior audit would provide a safe harbor against reclassification only if the facts are substantially the same and the previous audit raised the issue of worker status. H.R. 5011 and H.R. 4216 would limit the prior audit rule to employment tax audits.

audit, and if all necessary information returns have been filed, retroactive reclassification does not appear to be warranted.

The Definition of a "Substantially Similar Position"

The IRS has sometimes incorrectly focused on the particular job duties performed rather the structure of the relationship with the firm.[36]

Recommendtion The definition of substantially similar should be clarified so that it applies when service providers have a similar relationship to the service recipient. That is, it is the level of control exercised by the service recipient over the service provider that should determine similarity rather than the commonality of the particular duties performed by the service providers.

Long-Standing Industry Practice

The IRS interpretation of the concept of a "long-standing recognized practice of a significant segment of the industry" has produced IRS/taxpayer conflicts, particularly over what comprises a "significant segment" of an industry.

Recommendation The concept of industry practice should be clarified as follows:

1. *Long-standing* should not be interpreted so as to exclude newly emerging industries.
2. A practice that occurs in over 25 percent of the industry should be considered *significant.*
3. Taxpayer should have latitude in identifying the relevant *industry.* Relevant comparisons could range from firms in the same city to firms in the nation.
4. All reasonable types of *evidence* should be accepted, including surveys, letters from other firms, and oral statements. The IRS should be instructed to provide guidance as to appropriate standards for conducting industry surveys.

Application of Section 530 Beyond Employment Taxes

Section 530 was enacted as separate legislation and not as part of the Internal Revenue Code, probably because the need for it was viewed as temporary. This has two consequences: (1) It is not easily found by taxpayers, and (2) its relevance for purposes other than employment tax is not established.

Thus, it is possible for a worker to be classified as an independent contractor for employment tax purposes and as an employee for income tax and benefit plan purposes. The AICPA has expressed the problem as follows:

> the conflicting definitions in these areas (employer-employee, payroll, fringe benefit and retirement concerns) present a mine field waiting to explode on the small business person who must make employment decisions. As a result, we recommend uniformity regarding definitions of an employee in the fringe benefit and qualified retirement plan . . . .[37]

Recommendation Section 530 should, as amended in the above respects, be added to the Internal Revenue Code and made applicable for all relevant tax purposes. The desirability of this action is obvious. There is no justification for a service provider to be classified differently for payroll, fringe benefit and retirement purposes.

Permit IRS to Issue Additional Guidance

Section 530 prohibits the IRS from issuing guidance on classification matters, a prohibition that was meant to apply only temporarily during the time necessary for Congress to address the issues in the area.[38] The consequence of this prohibition is that taxpayers are frequently informed of IRS' interpretation of the rules in an ex post facto. . . . They cannot adjust their practices to reflect IRS' position before the audit because IRS interpretations are not published.[39]

Moreover, IRS agents, lacking the guidance necessary to assure uniform interpretation of the law, are flee in auditing taxpayers to interpret the law in the fashion that they individually prefer.[40]

Recommendtion The prohibition against IRS guidance should be repealed. Both taxpayers and IRS employees require guidance. The amendments to Section 530

[36] See, for example, *Lambert's Nursery and Landscaping, Inc.*, 894 F.2d 154 (5th Cir. 1990).
[37] Hearing Record of Select Revenue Measures Subcommittee, p. 134–5.
[38] HR Report 95–1748, p. 632.
[39] CGO, Hearing Record of Select Revenue Measures Subcommittee, p. 19.
[40] 36th Report CGO, p. 14; and ABA, Hearing Record of Select Revenue Measures Subcommittee, p. 127.

that are recommended above would sufficiently clarify the classification rules to warrant allowing the IRS to provide interpretive guidance.

PREPARED STATEMENT OF ROBERT J. MIRANDA

Chairman Moynihan, members of the Commit tee, thank you for inviting me to appear today. Senator Dole, thank you for your leadership in giving the Hispanic business community a voice on these important issues.

I am Robert J. Miranda, Chairman of the Taxation Committee of the *Hispanic Business* CEO Roundtable, a group of the 500 largest Hispanic owned businesses in the United States. In my professional capacity, I am a practicing certified public accountant with R.J. Miranda & Company, a southern California-based regional accounting firm. As financial advisor to numerous small and mid-size businesses, I have first hand experience in the day to day challenges faced by small businesses.

The Hispanic business community, more than 650,000 Hispanic-owned companies with annual revenues of approximately $25 billion, supports legislation to help control health care costs and provide affordable health care to all Americans. However, as a community of small and middle-market growth businesses, we are extremely concerned about the employer mandates included in the proposed Health Security Act. The tax provisions of this proposed legislation will seriously hurt our businesses.

A recent survey of Hispanic business owners revealed that 57% of Hispanic business owners were opposed to the proposed Health Security Act's employer mandates and increased government control of the health care system. A majority of Hispanic-owned businesses currently provide health insurance coverage to their employees.

My company provides full health insurance coverage to our 50 employees. Although in recent years we have experienced annual health insurance cost increases of 15%, the proposed Health Security Act will increase my health insurance cost by an additional 32%. I simply cannot pass this increased cost on to my clients if I am to remain competitive.

The *1987 Survey of Minority-Owned Businesses,* published by the U.S. Bureau of the Census, reported that Hispanic-owned firms increased 80.5% between 1982 and 1987. The U.S. Hispanic Chamber of Commerce estimates a 54% increase in the number of Hispanic businesses between 1987 and 1993. By the year 2000, *Hispanic Business* magazine projects 920,000 Hispanic-owned firms generating annual revenue of $58 billion.

Our community is made up of small to medium-sized companies, organized as sole proprietorships, partnerships and S corporations. The Health Security Act proposals for the definition of employee and self-employment taxation of S corporation and limited partnership income, affects our community in a big way.

These concerns are shared by our counterparts in the general small business community.

DEFINITION OF EMPLOYEE

The Administration's proposal seeks to prevent the misclassification of workers as independent contractors by businesses attempting to minimize payment of employer health care premiums. The proposed Health Security Act gives the IRS authority to issue prospective regulations on independent contractor status and, in effect, redefine the term employee These regulations will extend to all employment tax issues, not just health care premiums.

The proposed repeal of section 530 of the Internal Revenue Code and the concurrent granting of regulatory authority to the IRS to redefine "employee" will have dire consequences for the small business community. Section 530 of the Internal Revenue Code provides relief to the scores of small businesses who have been challenged by the IRS in audits involving reclassification of employees.

Congress should conduct a separate review of the independent contractor issue and *deny* the IRS broad discretion to determine the standards under which workers will be classified as employees. We do not believe that the Health Security Act should overturn significant tax policy directives of section 530 without a separate Congressional debate on independent contractor standards.

The Administration can prevent "gaming" of employment status by unscrupulous business owners intent on minimizing their payment of health care premiums. This may be accomplished by improving the matching of 1099 Form information against income reported by independent contractors. Hispanic business people support full compliance with tax laws. Aggressive prosecution of suspected violators is preferable to jeopardizing the status of all independent contractors.

MODIFICATION TO SELF-EMPLOYMENT TAX TREATMENT OF S CORPORATION AND LIMITED PARTNERSHIP INCOME

Under the Health Security Act, individuals owning more than 2 percent of the shares of an S corporation involved in a service-related business will have the entire income of their business treated as "net earnings from self-employment." Similar rules will apply to limited partners who materially participate in the operations of the partnership.

This proposed legislation is intended to subject all earnings from S corporations and limited partnerships involved in service-related business to self-employment tax and health care premiums. The Administration presumes that all earnings from these businesses represent income from our labor as opposed to a return on the capital invested in our businesses.

We are *concerned* that this proposed change in the tax laws creates more arbitrary and unwarranted redefinitions of income. Existing "reasonable compensation" standards are appropriate for addressing the perceived concerns of the Administration.

Even service-related businesses require capital reserves to operate over the long-term. S corporations and limited partnerships routinely keep earnings in the businesses to finance future operations. With today's limited availability of growth capital and bank financing, retention of earnings in a business is imperative. Further taxation of these retained earnings by application of self-employment taxes and health care premiums will hamper small business growth.

CONCLUSION

The entrepreneurial spirit is alive and well in the Hispanic community. A shining small business success is Alex Meruelo, a young Hispanic entrepreneur who started La Pizza Loca, Inc. in 1986 out of his home kitchen. Today, he manages a thriving publicly-traded chain of restaurants, employing 900 people and realizing annual sales of $15 million. This sole proprietorship has grown into a flourishing corporation expanding throughout the southwestern United States.

Entrepreneurs starting out as independent contractors, partnerships and S corporations represent the American dream of small business ownership. Some of our most innovative large companies, including Apple Computer and Federal Express, started as small businesses.

Distinguished members of the Finance Committee, we urge you to fuel the engine of entrepreneurship by rejecting runaway regulation, which will only slow our economic growth.

[Submitted by Senator Moynihan]

DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO WORKER CLASSIFICATION AND THE TAX TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS AND PARTNERS

[Scheduled for a Hearing Before the SENATE COMMITTEE ON FINANCE on May 3, 1994. Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, May 2, 1994, JCX-6-94]

INTRODUCTION

As part of its continuing examination of health care reform issues, the Senate Committee on Finance has scheduled a hearing on May 3, 1994, regarding proposals contained in the Health Security Act, (S. 1757 introduced by Sen. Mitchell and others and S. 1775 introduced by Sen. Moynihan) relating to worker classification and the tax treatment of certain S corporation shareholders and partners. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and of the proposals.

Part I of the document presents background and an overview of the issues covered in the pamphlet in the context of health care reform; Part II of the document relates to worker classification; and Part III relates to the tax treatment of certain S corporation shareholders and partners.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Proposals Relating to Worker Classification and the Tax Treatment of Certain S Corporation Shareholders and Partners* (JCX-6-94) May 2, 1994. The description and discussion is principally derived from the previous Joint Committee pamphlet: Joint Committee on Taxation, *Description and Analysis of Title VII of H.R. 3600, S. 1757, and S. 1775 ("Health Security Act")* (JCS-20-93), December 20, 1993.

I. Background and Overview

A. Worker Classification

Under present law, significant tax consequences result from the classification of a worker as an employee or an independent contractor.[2] Some of these favor employee status, while others favor independent contractor status.

The determination of whether a worker is an employee or an independent contractor is made under a common-law test. Under this test, a worker is generally considered an employee if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished. Whether the requisite control exists is determined based on all the facts and circumstances. The Internal Revenue Service (IRS) has developed a list of 20 factors that may be examined in determining worker status. These factors were developed by the IRS based on an examination of cases and rulings.

In the late 1960s, the IRS increased enforcement of the employment tax laws, and controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 ("section 530"), which generally permits a taxpayer to treat an individual as not being an employee for employment tax purposes regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment and if certain additional requirements are satisfied. Section 530 does not apply for income tax purposes. Thus, the determination of whether an individual is an employee for income tax purposes is made without regard to section 530.

The present-law rules for determining whether a worker is an employee or an independent contractor continue to result in misclassification of workers and uncertainty among taxpayers. While the section 530 safe harbor provides a relatively clear rule for determining worker status for employment tax purposes, the safe harbor does not apply in all cases, so many employers must rely on the subjective common-law test.

Health care reform proposals do not create the issue of proper worker classification, but put more pressure on the determination of worker status. To the extent that a health care proposal relies upon worker classification to determine an employer's or individual's liability for health care premiums, eligibility for Federal subsidies, or any additional health care or tax liabilities, the importance of worker classification is increased. The Health Security Act would place greater significance on the proper classification of a worker as an independent contractor or employee. In addition to the consequences of present law, under the Health Security Act the classification of a worker would affect whether or not the service recipient is required to pay a health care premium for the worker. It could also affect the amount the employer is required to pay (because the aggregate amount is based on firm size and employee wages) and the Federal subsidy for health care premiums. Whether it is more beneficial to be an employee or independent contractor may be different under the bill than under present law. The increased significance of worker classification would mean that there would be even greater need for clarity of rules to help prevent worker misclassification. From an administrative perspective, if there is an employer mandate, a clear definition of employee would make the system easier to administer both for the private sector and government agencies involved. The greater differences there are between the consequences of being an employee and not being an employee, the more likely employers and individuals would take aggressive positions in order to achieve the outcome they desire.

B. Self-Employment Tax Treatment of Certain S Corporation Shareholders and Partners

The present-law self-employment tax (SECA) on self-employed individuals is intended to parallel the FICA tax on wages of employees. Both taxes are intended to be imposed on the remuneration received from one's own labor. However, present-law SECA provides disparate treatment among different types of self-employed individuals (i.e., sole proprietors, general and limited partners in partnerships, and shareholders of S corporations) despite the fact that these individuals generally are treated similarly for Federal income tax purposes. In some cases the trade or business income of these individuals may be fully subject to SECA (e.g., in the case of sole proprietors and general partners); may be partially subject to SECA (e.g., in

[2] There also may be nontax consequences, such as the applicability of wage and hour laws.

the case of limited partners); or may be excluded from SECA (e.g., in the case of S corporation shareholders, whose salaries are subject to FICA).

Various rationales can be put forth as to why it is appropriate to treat various individuals differently for SECA purposes. These rationales focus on the extent to which the stakeholders of a flow-through entity are active participants or mere investors and how the are compensated for these roles. Partners in partnerships generally do not draw salaries. Thus, specific rules must be developed for the treatment of their earnings in the SECA base. In addition, the participation by limited partners in the activities of a partnership traditionally has been limited by local law. Because of the one-class-of-stock rule applicable to S corporations, shareholders that more actively participate in the corporation's business generally receive salaries as compensation for such activity. These salaries are subject to FICA. However, these traditional differences between general partners, limited partners, and S corporation shareholders are changing and differing employment tax treatment among such individuals may invite taxpayers to devise cosmetic structures to minimize their employment tax liabilities. In addition, to the extent that the Health Security Act or any other health care reform proposal relies upon the determination of aggregate wages (as defined under the employment tax rules), the significance of differing treatment among similarly-situated individuals increases.

The disparate treatment provided under SECA raises the following issues: (1) whether it is appropriate to provide different SECA rules for individuals who derive trade or business earnings from different types of flow-through entities; (2) whether it is possible to determine the theoretically correct employment tax bases for any or all types of self-employed individuals; and (3) whether it is possible to develop administratively feasible rules that adhere to these theoretical determinations.

II. Worker Classification Under the Health Security Act

A. DEFINITION OF EMPLOYEE AND PROTECTION AGAINST RETROACTIVE EMPLOYMENT TAX RECLASSIFICATIONS (SECS. 7301 AND 7303 OF THE BILL)

1. Present Law

In general

In general, the determination of whether an employer-employee or independent contractor relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished (Treas. Reg. sec. 31.3401(c)-(1)(b)). Whether the requisite control exists is determined based on the facts and circumstances.

The Internal Revenue Service (IRS) has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. Rev. Rul. 87-41, 1987-1 C.B. 296. The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a worker is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The 20 factors are designed as guides; special scrutiny may be required in applying the factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement.[3]

[3] The factors are as follows: (1) whether the worker is required to comply with instructions about when, where, and how to perform the work; (2) whether the service recipient trains the worker; (3) the extent to which the worker's services are integrated into the business operations of the service recipient; (4) whether the services must be rendered personally; (5) whether the service recipient supervises the worker; (6) whether there is a continuing relationship between the worker and the service recipient; (7) whether the service recipient sets the hours of work of the worker; (8) whether the worker is required to devote substantially full time to the business of the service recipient; (9) whether the work is done on the premises of the service recipient; (10) whether the worker must perform services in the order set by the service recipient; (11) whether reports by the worker to the service recipient are required; (12) whether payment is by the hour, week, or month; (13) whether the service recipient pays the worker's business and/or traveling expenses; (14) whether the worker is required to furnish his or her own tools; (15) whether the worker invests in facilities used to perform the work; (16) whether the worker can realize a profit or loss as a result of the performance of the services; (17) whether the worker performs services for more than one service recipient; (18) whether the worker makes his or her services available to the general public; (19) whether the service recipient has the right to discharge the worker; and (20) whether the worker has the right to terminate the relationship without incurring liability.

In addition to the common-law test, there are statutory provisions classifying workers as employees or independent contractors. Thus, for example, full-time life insurance salesmen are treated as employees for certain purposes pursuant to statutory provisions (secs. 3121(d) and 7701(a) (20)). Similarly, certain real estate agents and direct sellers are not treated as employees (sec. 3508).

Section 530 of the Revenue Act of 1978

In the late 1960s, the IRS increased enforcement of the employment tax laws, and controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 ("section 530"), which generally permits a taxpayer to treat an individual as not being an employee for employment tax purposes regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment and if certain additional requirements are satisfied.[4] Section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[5]

Under section 530, a reasonable basis is deemed to exist for a period if the taxpayer reasonably relied on any of the following: (1) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer; (2) a past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by the individual in question; or (3) longstanding recognized practice of a significant segment of the industry in which such individual was engaged. These factors are a safe harbor, not the. exclusive means of meeting the reasonable basis requirement.

In order to qualify for section 530 relief, certain conditions must also be satisfied. In particular, section 530 does not apply if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after December 31, 1977. In addition, section 530 does not apply unless all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee.

Section 530 also bars the Department of Treasury (including the IRS) from publishing any regulation or revenue ruling classifying individuals for purposes of employment taxes under interpretations of the common law. Taxpayers may, however, obtain private letter rulings from the IRS regarding the status of workers.

Section 530 does not apply for income tax purposes. Thus, the determination of whether an individual is an employee for income tax purposes is made without regard to section 530.

2. Description of Bill

In general

The bill would (1) repeal section 530 of the Revenue Act of 1978, (2) codify a modified version of section 530 which protects taxpayers against retroactive reclassification of workers as employees, and (3) give the Secretary of the Treasury the authority to define the term "employee" by regulation. The modified rules would apply for income tax purposes, employment tax purposes, and for purposes of the bill's health care provisions.

Codification and revision of section 530

The bill would repeal section 530 of the Revenue Act of 1978 and incorporate a modified version in the Internal Revenue Code. Under the bill, an individual would not be treated as an employee of a taxpayer for any period if, for that period:

(1) the taxpayer treats the individual as not being an employee;

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[4] The relief granted by section 530, initially scheduled to terminate at the end of 1979, was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248), the Congress extended the section 530 relief indefinitely, pending enactment of further statutory rules regarding the classification of workers as employees or independent contractors.

[5] This provision was contained in section 1706 of the Tax Reform Act of 1986, (P.L. 99-514) effective for remuneration paid and services rendered after December 31, 1986.

(2) the taxpayer treats the individual (and all other individuals holding substantially similar positions) as not being an employee for employment tax purposes for such period and all prior periods;

(3) a return filing requirement is met;

(4) a safe harbor requirement is met; and

(5) the Secretary has not notified the taxpayer in writing before the beginning of such period that the Secretary has determined that the taxpayer should treat such individual (or any individual holding a substantially similar position) as an employee.

The return filing requirement would be met if all Federal tax returns (including information returns) required to be filed by the taxpayer for such period with respect to such individual (and all other individuals holding substantially similar positions) were timely filed on a basis consistent with the taxpayer's treatment of such individuals as not being employees. For purposes of this requirement, a return that was not timely filed would be considered to have been timely filed if the penalty for failure to file is reduced or waived because the failure was corrected or because it was a de minimis failure pursuant to section 6721 (b) and (c). In addition, the taxpayer would not fail to satisfy the return filing requirement solely because the taxpayer failed to timely file accurate information returns with respect to individuals holding substantially similar positions if the taxpayer substantially complied with reporting requirements (as defined in proposed new Code sec. 6721(a)(3)).

The safe harbor requirement would be met with respect to an individual for any period if treating such individual as not an employee was:

(1) in reasonable reliance on a written determination regarding the taxpayer that addressed the employment status of the individual or an individual holding a substantially similar position;

(2) in reasonable reliance on a concluded IRS audit which was for a period in which the rules for determining 'employment status were the same as for the period in question, and in which the employment status of the individual (or an individual holding a substantially similar position) was examined and accepted;

(3) in reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the individual is engaged; or

(4) supported by substantial authority (excluding for this purpose letter rulings regarding other taxpayers).

No other means could be used to demonstrate reasonable reliance.

The prior audit safe harbor would cease to apply to an individual for a period if the treatment of such individual as not being an employee is inconsistent with any regulation, revenue ruling, revenue procedure, or other authority published by the Secretary before the beginning of the period and after conclusion of the audit on which the taxpayer is relying.

The availability of the industry practices safe harbor would terminate for all workers for periods beginning after the date on which the Secretary prescribes regulations defining "employee" and could terminate with respect to particular workers for earlier periods if the treatment of such workers as not being employees was inconsistent with any other regulation, revenue ruling, revenue procedure, or other authority published by the Secretary before the beginning of such earlier period.

The bill would provide that if an individual was treated as not being an employee under the safe harbor rules for employment taxes, then the individual would be treated as self-employed for income tax purposes as well.

Treasury regulations defining employee

The bill would authorize the Secretary of the Treasury to prescribe rules for determining whether an individual is an employee. These rules would apply for employment tax purposes and, to the extent provided in the regulations, for income tax purposes. Such regulations could modify the rules otherwise applicable for determining whether someone is an employee, except for certain statutory rules. The regulations would be required to give significant weight to the common-law rules. The following statutory provisions could not be modified by the regulations: (1) the rules providing that the following persons are treated as employees (a) corporate officers (sec. 3121(d)(1)), (b) certain agent-drivers or commission drivers, full-time life insurance salesmen, home workers, and traveling salesmen (sec. 3121(d) (3)); and (c) individuals who perform services that are included under an agreement entered into pursuant to section 218 of the Social Security Act (relating to voluntary coverage of certain State and local government employees) (sec. 3121(d) (4)); (2) the rule providing that for employment tax purposes a person who provides companion sitting services is not an employee of any person who places the individual with the service recipient (sec. 3506); (3) the rule providing that certain real estate agents and direct

sellers are not employees (sec. 3508); and (4) the new safe harbor provisions described above (proposed new Code sec. 3511). The regulations issued under this provision could not be effective earlier than 6 months after the regulations are promulgated as final regulations. When the regulations are issued, the Secretary of the Treasury is to submit a report to Congress relating to such regulations, including an explanation of their purposes and the issues they were designed to address.

Effective date.—The provision relating to section 530 would generally be effective for periods beginning after December 31, 1995, except that the repeal of the prohibition on the issuance of regulations and rulings would be effective on the date of enactment. The provision authorizing regulations defining "employee" would be effective on the date of enactment.

3. Discussion of Issues

Tax issues relating to the definition of employee

Under present law, significant tax consequences result from the classification of a worker as an employee or an independent contractor.[6] Some of these differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. They also relate to whether the service recipient has to include the worker for pension or other employee benefit plan purposes. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

The present-law rules for determining whether a worker is an employee or an independent contractor continue to result in misclassification of workers and uncertainty among taxpayers. While the section 530 safe harbor provides a relatively clear rule for determining worker status, the safe harbor does not apply in all cases, so many employers must rely on the common-law test.

Misclassification of workers can be either inadvertent or deliberate. At the extremes, it will be clear whether a worker is properly characterized as an employee or an independent contractor. However, many work situations involve the grey area in between—some of the 20 factors may support employee status, while some may indicate independent contractor status. Thus, it may be difficult to determine whether a particular case of misclassification was deliberate or inadvertent.

Inadvertent misclassifications can occur because the determination of proper classification is factual and reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. Taxpayers wishing certainty can obtain a private letter ruling regarding the status of workers. However, not all taxpayers may wish to undertake the expense of obtaining a ruling or may not be able to wait for a ruling from the IRS. Thus, although the prohibition on issuance of general guidance by the IRS may make the likelihood of such errors greater, the IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and the IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement.

Misclassification of workers as independent contractors may also be deliberate. In some cases, workers and service recipients may prefer to classify workers as independent contractors, both for tax and nontax reasons. For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. A service recipient may wish to avoid the administrative burden associated with withholding income and employment taxes. The service recipient also may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors.

The bill would place greater significance on the proper classification of a worker as an independent contractor or an employee.[7] In addition to the consequences of

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[6] There may also be nontax consequences, such as applicability of wage and hour laws.

[7] The health care provisions of the bill may also affect whether firms out-source some of their work or hire subcontractors to perform it because the amount of Federal subsidies and employer premiums may vary based on whether work is performed by subcontractors or through similar arrangements. While some of these arrangements may involve questions as to whether the

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present law, under the bill the classification of a worker would affect whether or not the service recipient is required to pay a health care premium for the worker. It could also affect the amount the employer is required to pay (because the aggregate amount is based on employee wages) and the Federal subsidy for health care premiums. Whether it is more beneficial to be an employee or independent contractor may be different under the bill than under present law. The increased significance of worker classification would mean that there would be even greater need for clarity of rules to help prevent worker misclassification.

Section 530 is supported by those who take advantage of it because it provides some certainty and protection to taxpayers in an area of law that is far from clear. However, section 530 has also been criticized. Not all taxpayers can use the section 530 safe harbors. For example, the consistency requirement may prevent some taxpayers from using section 530. Taxpayers who cannot take advantage of section 530 argue that it creates a competitive disadvantage that is particularly unfair because they are classifying their workers under the general rule. Section 530 has also been criticized because it may take very little to come within one of the safe harbors if section 530 is otherwise available to a taxpayer. For example, the prior audit rule has been criticized because the audit need not have been an employment tax audit. Thus, section 530 could apply even if worker status was not raised on the audit. The industry practice safe harbor has been criticized on the ground that it rewards people who have consistently misclassified workers. Limiting the scope of these provisions would be viewed as more fair to taxpayers who cannot take advantage of section 530, and would also be more consistent with tax policy concerns.

Codifying the safe harbors could provide more certainty to taxpayers. In addition, lifting the prohibition on issuance of guidance would enable the IRS to issue clarifying rules. Overall, however, it is difficult to determine what effect the provisions of the bill would have on classification of workers. It is not clear to what extent modifying the safe harbors will actually reduce the number of taxpayers who take advantage of them. For example, a taxpayer that was relying on the prior audit safe harbor but could not do so under the bill might rely instead on the industry practice safe harbor. The bill would give the Treasury Department the authority to terminate the application of the industry practice safe harbor, but until actual rules are proposed, it is difficult to determine what effect they will have. The same issue arises in trying to determine what effect regulations defining "employee" would have. Clarifying the statutory rules would provide more certainty to both taxpayers and the IRS.

Another way to deal with the misclassification issue, other than clarifying the rules, would be to reduce the differences between the treatment of employees and independent contractors. The more the two groups of workers are treated the same for purposes of the employer mandate and the receipt of Federal subsidies, the less pressure there will be on the definition of employee. It has also been suggested that compliance problems could be addressed, such as requiring withholding on payments to independent contractors.[8]

Under present law, section 530 applies only for employment tax purposes. In general, the provision would apply the same definition of employee for income tax purposes and employment tax purposes. This would likely reduce taxpayer confusion and ease administration of the tax rules. Under present law, some individuals who are treated as not being employees under the safe harbor mistakenly use that status in filing their income tax returns. A single definition would avoid such mistakes.

Health care policy issues

The question of who is an employee is fundamental to the provisions of the bill because it has a mandated employer contribution.[9] The question of whether there should be such a mandate and whether or not health care should be delivered through the employer is obviously a central issue in health care reform.[10] From an administrative perspective, if there is an employer mandate, a clear definition of employee would make the system easier to administer both for the private sector and government agencies involved. The greater differences there are between the consequences of being an employee and not being an employee, the more likely em-

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worker is an employee of the service recipient, in many cases the question will not arise because the worker is the employee of the subcontractor.

[8] See, U.S. General Accounting Office, *Approaches for Improving Independent Contractor Compliance,* GAO/GGD-92-108 (July 1992)

[9] Worker classification issues also may arise in health care proposals that do not have a mandated employer contribution.

[10] Discussion of issues relating to employer mandates and use of an employer-based health care delivery system is beyond the scope of this pamphlet.

ployers and individuals would take aggressive positions in order to achieve the outcome they desire.

Even if there is to be an employer mandate or employer-based system, it is not clear that the definition of employee for health care purposes should be the same as it is for other purposes. Different policies may underlie the health care rules and income and employment tax rules, and these policies could lead to different conclusions about proper classification. Thus, it may not be necessary to examine the question of worker status for income and employment tax purposes in the context of health care reform. On the other hand, overall administrative burdens on employers, individuals, the IRS, and those responsible for administering the health care system and the income and employment tax systems would be less if the rules are the same.

B. INCREASE IN PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS WITH RESPECT TO NON-EMPLOYEES (SEC. 7302 OF THE BILL)

1. Present Law

Information reporting requirements

The Code contains a number of information reporting requirements. One requires that a person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income, must file an information return with the IRS reporting the amount of such payments, as well as the name, address and taxpayer identification number of the person to whom such payments were made.[11] A similar statement must also be furnished to the person to whom such payments were made.[12]

The Code contains an additional provision requiring that a service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more.[13] Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and taxpayer identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.[14]

Failure to file correct information returns

Any person that fails to file a correct information return[15] with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed (sec. 6721). If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

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[11] Sec. 6041(a). A number of exceptions to this requirement are provided in Treasury regulations. In addition, to the extent the general information reporting requirements of this provision overlap specific information reporting requirements elsewhere in the Code, taxpayers are generally required to report only once, under the more specific information reporting provision.

[12] Sec. 6041(d).

[13] Sec. 6041A(a).

[14] Sec. 6041A(e).

[15] This term is defined in sec. 6724(d)(1), and refers to 21 information reporting requirements in the Code, including secs. 6041(a) and 6041A(a).

In addition, special, lower maximum penalty levels apply for small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent 3 taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Failure to furnish correct payee statements

Any person that fails to furnish a correct payee statement[16] to a taxpayer on or before the prescribed due date is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year (sec. 6722). If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, there is a penalty of $100 per statement or, if greater, 10 percent[17] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year (sec. 6723). The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or a statement and any requirement to furnish a correct taxpayer identification number to another person.

Waiver, definitions, and special rules

Any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect (sec. 6724). For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.

2. Description of Bill

The bill would modify the penalty for failure to file correct information returns with respect to two types of information returns: (1) information returns under section 6041(a) which relate to payments to any person for services performed by such person (other than as an employee);[18] and (2) returns regarding remuneration for services under 6041A(a). In general, both of these sections of the Code relate to information returns with respect to payments made to non-employees, such as independent contractors.[19]

In general, the bill would increase the penalty for failure to file correct information returns on or before August 1 from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported correctly but not so reported.

The bill would also provide for an exception to this increase where substantial compliance has occurred. The bill would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported under these two sections of the Code for that calendar year is at least 97 percent of the aggregate amount required to be reported under these two sections of the Code for that calendar year. If this exception applies, the penalty of $50 for each return would continue to apply.

The present-law reductions in the $50 penalty where correction is made within a specified period, the exception for de minimis failures, and the lower limitations for persons with gross receipts of not more than $5,000,000 would not be affected by the bill. Also, the penalty for failure to furnish correct payee statements, the penalty for failure to comply with other information reporting requirements, and the reasonable cause rules would not be affected by the bill.

Effective date.—The provision would apply to information returns the due date for which (without regard to extensions) is more than 30 days after the date of enactment.

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[16] This term is defined in sec. 6724(d)(2), and refers to 22 information reporting requirements in the Code, including secs. 6041(a) and 6041A(a).

[17] Five percent for several types of statements.

[18] It is intended that the modification to the penalty apply only to information returns reporting payments for services performed that are made to non-employees under section 6041(a), and not with respect to other types of information returns filed under section 6041 (a). A technical correction to the statutory language may be necessary to effect this result.

[19] Employers are required to provide information with respect to wages paid to their employees on Form W-2 under section 6051; consequently, those information returns would not be affected by the bill.

3. *Discussion of Issues*

One issue to consider is whether the increase in the penalty for failure to file correct information returns will result in a penalty that is proportional to the offense of failing to report. Some might argue that the resulting penalty could be disproportionately high, particularly in light of the fact that intentional disregard or willfulness are not required to be asserted or proven in order to impose the higher penalty. Others might argue that the penalty is not disproportionate to the offense because information returns filed by companies with respect to the independent contractors they engage are the principal means by which the IRS learns from someone other than the taxpayer of the existence and amounts of these payments. This is important under the bill because some self employed individuals will be entitled to discounts on their health insurance premiums based upon their income, so that correct reporting of payments will be necessary to determine entitlement to these discounts. In addition, some might argue that the increased penalty is not disproportionate because the increase does not apply where correction is made within a specified period, within certain de minimis guidelines, or where there is reasonable cause.

An additional issue to consider is how well the increased penalty fits into the current information reporting penalty structure. For example, the increased penalty is parallel in structure to the penalty for intentional disregard of the information reporting requirements (sec. 6721(d)). The difference is the rate: the increased penalty would be 5 percent of the amount required to be reported, while the penalty for intentional disregard is 10 percent. Consideration might be given as to whether the differential between the two penalties should be adjusted. Another aspect of how the increased penalty fits into the current information reporting penalty structure is whether the increased penalty should also apply to failures to furnish correct payee statements (sec. 6722). Under the bill, the increased penalty applies only with respect to the failure to file a correct information return with the IRS, and it does not apply to the failure to provide a correct copy of the information return to the individual with respect to whom the information is reported. Another aspect of how the increased penalty fits into the current information reporting penalty structure is whether, in light of this increased penalty, the overall annual caps on the total amount of penalty that may be imposed should remain the same (as they do under the bill) or should be adjusted.

III. MODIFICATION TO SELF-EMPLOYMENT TAX TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS AND PARTNERS

(Sec. 7141 of the bill)

A. PRESENT LAW

Employment taxes, in general

As part of the Federal Insurance Contributions Act (FICA), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is composed of two parts: old-age, survivor, and disability insurance (OASDI) and Medicare hospital insurance (HI). For wages paid in 1993, to covered employees, the OASDI tax rate is 6.2 percent on both the employer and employee on the first $57,600 of wages and the HI tax rate is 1.45 percent on both the employer and employee on the first $135,000 of wages.

Similarly, under the Self Employment Contributions Act (SECA), a tax is imposed on an individual's net earnings from self-employment (NESE). The SECA tax rate is the same as the total FICA rates for employers and employees (i.e., 12.4 percent for OASDI and 2.9 percent for HI) and, for 1993, is capped at the same levels. In general, the SECA tax is reduced to the extent the individual had wages for which FICA taxes were withheld during the year.

The cap on wages and NESE subject to the OASDI portion of FICA and SECA taxes is indexed to changes in the average wages in the economy. The cap on wages and NESE subject to the HI tax is repealed for wages and income received after December 31, 1993.

Treatment of partners and S corporation shareholders

The NESE of a partner in a partnership generally is the partner's distributive share from any trade or business of the partnership, adjusted for certain items of income that are passive in nature (e.g., rentals of real estate, dividends, and interest are excluded from NESE unless such amounts are received in the course of a trade or business of a dealer in the related property). However, the distributive share of a limited partner generally is excluded from NESE except to the extent the distributive share is a guaranteed payment for services actually rendered to or on behalf of the partnership.

Similar rules are not provided for shareholders in S corporations.[20] Thus, shareholders are not required to include as NESE their pro rata share of the income of an S corporation.[21] Rather, shareholders who perform services for the S corporation are subject to FICA taxes on the wages paid to them.[22]

B. DESCRIPTION OF BILL

The bill would: (1) amend the definition of NESE to include the pro rata share of certain S corporation income of certain shareholders and (2) modify the NESE rules applicable to limited partners in a partnership, for SECA tax and health insurance premium purposes.

Under the bill, in the case of a "2-percent shareholder" of an S corporation for any taxable year who materially participates in the activities of the corporation during the year, NESE would include the shareholder's pro rata share of taxable income or loss from "service-related businesses" carried on by the S corporation. A "2-percent shareholder" would be any shareholder that owns more than 2 percent of the stock of an S corporation at any time during the year (sec. 1372(b)). The shareholder's pro rata share of the income or loss of an S corporation would be determined pursuant to the general rules of subchapter S (sec. 1366). A "service-related business" would be any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees. The present-law exclusions from NESE for certain passive income that apply to partnerships would also apply to S corporations.

The bill also would amend the treatment of limited partners in a partnership by providing that the distributive share of a limited partner would be excluded from NESE only if the partner does not materially participate in the activities of the partnership. The provision retains the present law guaranteed payment rule for limited partners who provide services for the partnership.

The bill would make conforming amendments to the Social Security Act.

Effective date.—The provision would apply to taxable years of individuals beginning after December 31, 1995, and to taxable years of S corporations and partnerships ending with or within such taxable years of individuals.

C. DISCUSSION OF ISSUES

Disparities created by present law

In general, partnerships and their partners and S corporations and their shareholders are treated similarly for Federal income tax purposes. The income of a partnership or S corporation is not subject to tax at the entity level, but rather is flowed through to the partners or shareholders and reported on their individual income tax returns, regardless of whether or when the income is actually distributed to the individuals. In contrast, the income of a subchapter C corporation is subject to an entity-level income tax when it is earned and is subject to the individual income tax when it is distributed to the individual shareholders of the corporation.

The SECA tax on the earnings of self-employed individuals parallels the FICA tax on the wages of employees. Both taxes are intended to be imposed on remuneration received for one's own labor. Under this theory, income that is a return on capital investment should not be subject to SECA. Difficulties arise when an individual provides both investment capital and labor services to an enterprise and has control over whether the remuneration for such services is in the form of salary (subject to FICA) or a distribution of the net earnings of the enterprise (generally subject to neither FICA nor SECA when distributed). This issue is less problematic with

[20] For some purposes, a shareholder that owns more than 2 percent of the stock of an S corporation is treated as a partner in a partnership (sec. 1372(a)). However, this rule does not apply for employment tax purposes.

[21] See, Rev. Rul. 59-221, 1959-1 C.B. 225.

[22] Furthermore, a shareholder of an S corporation may be subject to FICA tax even if the shareholder is not paid amounts denominated as "wages" by the corporation. In Rev. Rul. 74-44, 1974-1 C.B. 287, the IRS held that two shareholders who performed services for an S corporation but did not draw salaries were subject to FICA tax on dividend distributions from the corporation because the dividends represented reasonable compensation for the services performed. The present-law validity of this 1974 ruling following the substantial revision of the rules that apply to S corporations and their shareholders in 1982 is unclear.

However, it is the present position of the IRS that if a shareholder is an officer of an S corporation and performs substantial services, such shareholder is an employee of the corporation whose income is subject to FICA (but not SECA) tax. See, Department of the Treasury, "Tax Guide for Small Businesses" (for use in preparing 1992 returns), Publication 334, p. 136.

respect to services provided by a shareholder-employee of a subchapter C corporation because there is an incentive to pay the individual a salary (subject to FICA) in order to claim a corporate income tax deduction for such amount. However, no such incentive applies with respect to flow-through entities. Thus, rules are needed to determine what portion, if any, of the income of a partnership or S corporation is subject to SECA at the partner or shareholder level.[23]

Present law treats all trade or business income earned by a partnership and allocated to *general* partners as NESE, regardless of whether such partners are material participants or mere investors. Thus, present law assumes that all partnership trade or business income that is allocated to a general partner is remuneration for services performed by the partner. Income allocated to *limited* partners is not NESE (unless in the form of a guaranteed payment for services rendered), on the theory that such partners have limited participation in the operation of the partnership and should not be entitled to social security benefits by virtue of their investment.[24]

Under present law, income allocated to a shareholder in an S corporation is not subject to NESE. This exclusion may be based on the theory that because S corporations are allowed to have only one class of stock, a shareholder that provides services to the corporation would draw a salary for such services, while a passive co-investor shareholder would not.[25] For example, assume two individuals form an S corporation by making equal capital contributions. One shareholder provides services to the venture and the other does not. Because the two shareholders have an equal number of shares in the corporation, a salary (subject to FICA) is needed in order to adequately compensate the service provider. Any income remaining after the payment of the salary would be deemed a return on the capital investments of the shareholders and not subject to SECA or FICA taxes. However, the application of this theory may result in an under-inclusion of earnings for employment tax purposes in some cases. For instance, if both shareholders in the example above provide an equal amount of services to the corporation, there is no need to pay salaries to equalize their contributions, and each shareholder's pro rata share of the corporate earnings would not be subject to SECA (although the IRS may contend that the shareholders are subject to FICA on all or a portion of the S corporation's earnings).[26]

If the two individuals in the two examples above formed a general partnership rather than an S corporation, each partner's distributive share of partnership trade or business income would be NESE, regardless of the level of activities by the partners. Thus, present law treats general partners in a partnership differently than shareholders in an S corporation for employment tax purposes, despite the fact that a partnership and its partners and an S corporation and its shareholders are treated similarly for income tax purposes.

Treatment under the bill

The bill would broaden the SECA base and narrow the disparate SECA treatment between income earned by partnerships and S corporations by treating as NESE the pro rata share of income of certain S corporation shareholders. Under the bill, NESE would include the pro rata share of S corporation income: (1) of a 2-percent shareholder; (2) who materially participates in the activities of the corporation; (3) but only to the extent the income is from a service-related trade or business. Each of these three tests raise certain issues.

Two-percent shareholders.—Present law treats 2-percent shareholders as individuals in control of the corporation for fringe benefit purposes (sec. 1372(a)). Thus, the

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[23] It should be noted that because the determination of NESE generally is based on income tax rules, the method by which a business is capitalized also affects the NESE of the owner. A business that is capitalized with debt generally will generate lower NESE than an a business that is capitalized with equity because the returns on debt (interest expense) are deductible while the returns on equity (dividends, distributive share, etc.) are not.

[24] Legislative history indicates that the definition of NESE was amended to exclude distributive shares of limited partners because of a concern that certain business organizations were soliciting investments in limited partnerships as a means for the investor to become insured for social security benefits. House Ways and Means Committee Report on P.L. 95-216 (1977).

[25] Conversely, partnerships are viewed as entities that allow greater flexibility with respect to the allocation among the partners of income or loss from partnership activities. Partnerships do not pay salaries for services rendered by the partners. Rather, the partnership agreement may provide special allocations of partnership income to those partners who provide services to or on behalf of the partnership. Such allocations of income may be respected for Federal income tax purposes if they have substantial economic effect.

[26] The identical issue arises if the corporation is owned by a sole shareholder. It is reported that, based on 1990 data, approximately 80 percent of S corporations have only one or two shareholders. Susan C. Nelson, "S Corporations: The Record of Growth After Tax Reform," *Journal of S Corporation Taxation*, Vol. 5, No. 2, Fall 1993, p. 146.

"2-percent shareholder" test of the bill appears consistent with the present-law treatment of 2-percent shareholders for employment related purposes. In addition, in practice, most S corporation shareholders who are not 2-percent shareholders likely are employees whose wages are subject to FICA or minority investors who are not involved in the operations of the corporation.

Material participation.—Under the bill, a 2-percent shareholder need not include his or her pro rata share of S corporation earnings as NESE unless the shareholder materially participates in the activities of the S corporation. This test may be appropriate under the theory that a shareholder's pro rata share of S corporation earnings is not remuneration for the services provided by the shareholder unless the shareholder materially participates in the activities of the corporation.

In many instances, the material participation test may be redundant with the 2-percent shareholder test (e.g., in the case of an S corporation owned by a sole shareholder-employee). However, where there are multiple shareholders with multiple duties, a determination as to the material participation of each shareholder would be required. These determinations may be difficult. The bill does not define "material participation." The term is used under SECA to include certain farm rental income as NESE (sec. 1402(a) (1)),[27] as well as elsewhere in the Code to determine whether an individual may deduct losses from certain activities in which he or she materially participates (the passive loss rules of sec. 469). Under the passive loss rules, "material participation" means involvement in the operations of an activity on a basis that is "regular, continuous, and substantial," a more rigorous test than under section 1402.[28] Treasury regulations under sections 469 and 1402 provide further guidance as to when a taxpayer's involvement constitutes material versus passive participation, for the respective purposes of the two provisions. Despite this guidance, however, the determination of "material participation" under either section is often thought to be a difficult and subjective process.

The bill also would apply a material participation test (but not the "2-percent shareholder" or "service-related trade or business" tests) to limited partners. Section 469 provides that, except as provided in regulations, the activities of limited partners do not constitute material participation. Treasury regulations provide instances in which the activities of a limited partner override this presumption. In general, it is more difficult for a limited partner to sustain material participation than it is for a general partner under section 469.

Although "material participation" may be an appropriate standard for determining when the activities of an S corporation shareholder or limited partner give rise to earnings that should be subject to SECA, the application of such a standard may be administratively difficult. Conversely, if the application of the standard proves to be administratively feasible, consideration should be given to applying the standard to general partners in partnerships as well.

Service-related trade or business.—Under the bill, only the portion of the pro rata share of the income or loss of a 2-percent shareholder who materially participates that is attributable to certain service-related trades or businesses is subject to NESE. This test would require an S corporation to determine if it is engaging in such activities and, if it is, to segregate the earnings from such activities from earnings of other activities. "Service-related trade or business" is defined with reference to a provision that was enacted with the Omnibus Budget Reconciliation Act of 1993 that allows for a partial capital gains exclusion for the gain on the sale of the stock of certain corporations engaged in active trades or businesses (sec. 13113 of the 1993 Act, adding sec. 1202 to the Code). "Service-related trade or business" generally means the activities of certain professions that are more dependent upon personnel skills than upon capital investment.

The "service-related trade or business" test may create some administrative' difficulties. It may be difficult for an S corporation to determine if it is engaging in covered activities, due to the relative newness and subjectivity of the term.[29] Fur-

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[27] Under present law, the NESE of a owner or lessee generally does not include rent paid in a share of agricultural or horticultural production pursuant to an arrangement unless the owner or lessee materially participates in the production or management of the commodity produced.

[28] It should be noted that "material participation" is used for different purposes under sections 469 and 1402. Under section 1402, the term is used to expand the SECA tax base to include the farm income of certain individuals. Under section 469, the term is used to determine whether certain losses incurred by individuals are deductible for income tax purposes. Thus, an individual generally would want to be a "material participant" for income tax purposes with respect to loss-generating activities, but would not want to be a "material participant" for SECA purposes with respect to certain farm income-generating activities.

[29] Present-law sections 401(c)(2) (relating to employee benefit plans) and 911(d)(2) (relating to an exclusion for foreign earned income) of also provide distinctions between income earned from personal services and other income. Neither definition was adopted by the provision.

thermore, if an S corporation engages in more than one business, it would be required to segregate the earnings from covered activities from other activities (e.g., an allocation may be necessary if an S corporation is involved in both architectural design and building construction). Income determinations for separate trades or businesses are particularly difficult (and manipulable) where the different trades or businesses share common costs such as overhead or interest expense. In addition, the use of a "service-related trade or business" test may provide an incentive for a service provider to break-up a single business into separate lines of business in order to minimize its NESE (e.g., an accounting firm that prepares computer-generated tax returns may claim to be in two businesses-the provision of income tax advice and the mechanical preparation of tax returns.)

The "service-related trade or business" test may be deemed appropriate for SECA purposes on the theory that passive investors are unlikely to invest where the success of the business is dependent upon the skills of another individual rather than the application of capital. As such, the "service-related trade or business" test may be redundant with the "2-percent shareholder" and "material participation" tests and may add little other than complexity to the employment tax rules. Conversely, if an entity-level activity test is appropriate as a separate standard for SECA purposes and is administrable, the question arises as to whet her the test should be applied to partnerships as well. For example, under the bill, NESE would include income from manufacturing activities conducted through a general partnership, but not through an S corporation.

Other employment tax exceptions

In many instances, the bases for the FICA and SECA payroll taxes are broader than the base of the income tax with respect to the earned income of individuals. For example, several deductions and exclusions that are allowed for income tax purposes are not allowed for employment tax purposes.[30] The bill would further expand the SECA base to include additional trade or business income of self-employed individuals by eliminating present-law exceptions with respect to the incomes of certain S corporation shareholders and limited partners. If one of the goals of the bill is to expand the employment tax bases to include as much earned income as possible, consideration should be given as to whether there are any other present-law exceptions and whether these exceptions are warranted. One question to be kept in mind in determining whether an employment tax exception is warranted is whether the individual should be entitled to social security (or health care) benefits by virtue of the activity to which the exception applies.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Thank you, Mr. Chairman. Let me begin by directing my comments to this Administration, and my deep concerns about the direction your proposals are taking America's small businesses. I think that far too many of the tax proposals coming out of this Administration are needlessly aimed at the small businesses that are the backbone of this nation's economy. In fact, between 1988 and 1990, small businesses created 4.1 million jobs, while big business lost some 500,000 jobs. They are the essential ingredient in an improving economy for this country.

Despite this fact, this Administration chose to raise taxes of well over $25 billion through tax rates on truly small businesses that have *less than $10 million in gross receipts* and reinvest *all* of their earnings back into the business. This figure is from to the Joint Committee on Taxation, however, I believe the number is significantly higher. The new Clinton tax increase from last year has resulted in these small businesses paying tax rates of up to 42.5% compared to giant corporations that have a maximum tax rate of 35% on their reinvested profits! Small businesses pay tax rates that are more than 20% higher than the largest businesses in the country thanks to the Clinton tax increase last year.

That's why I introduced legislation to roll back these gigantic tax increases on small businesses that reinvest their profits—that was Senate bill S. 2030, and our colleague Senator Wallop joined me on that, as did many others. This Administration is clearly moving in the opposite direction concerning taxes on small businesses.

There are also new proposals from the Clinton Administration to *retroactively* raise regulatory penalties on these small businesses. They represent giant increases

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[30] For example, the net operating loss deduction of section 172, the personal exemptions of section 151, and the exclusion for income earned abroad of section 911 are not allowed for SECA purposes.

in potential liabilities from organizations like OSHA and EPA. I guess this is strike two from the Clinton Administration on small businesses.

Now comes strike three as we are having hearings today on new proposals to raise tax rates again on exactly these same small businesses. In fact, the proposal to tax Subchapter S corporations amounts to nothing less than a 3% tax rate increase on these businesses. And your proposal to change the tax treatment of independent contractors is going to result in fewer jobs for Americans. This Committee has been through that debate, and I, for one, am strongly opposed to giving full authority to the IRS to write the rules in this area of the tax law. The worst part is, none of these changes in the tax law are necessary in order to get the health care reform that you want. In reality, this is just another effort to raise more taxes on America's small business men and women.

PREPARED STATEMENT OF LESLIE B. SAMUELS

Mr. Chairman and Members of the Committee: I am pleased to present the views of the Administration on the following tax provisions of the Health Security Act (the "Act"): provisions relating to workers' employment status, including modifications in the current rules for determining that status and increased penalties for failure to report payments made to independent contractors for services; a modification in the self-employment tax treatment of certain S corporation shareholders and limited partners; provisions relating to the tax treatment of health care organizations; provisions relating to the tax treatment of employer-provided health care; and, finally, increases in excise taxes on tobacco products. These are provisions being considered by the Committee in hearings last week and today.

The Administration believes that the approaches it has taken concerning the tax-related issues in the Act represent an appropriate means of furthering the goals of the Act and are consistent with sound tax policy. We recognize, however, that many of these issues are complex and that there may be other ways to accomplish the same objectives. Moreover, as the President has indicated, the Administration wishes to be flexible concerning the details of health care reform while meeting the goal of universal coverage. In keeping with that flexibility, we would be pleased to consider alternative approaches to the issues before the Committee today that may be offered during these hearings or in the course of the legislative process. We are committed to work with this Committee and interested taxpayers to develop fair and effective rules.

I. PROVISIONS RELATING TO EMPLOYMENT STATUS

A. Determining Workers' Status

Overview

A fundamental feature of the Act is universal coverage. To accomplish universal coverage with the least disruption, the Act builds on the current system, in which nine out of ten Americans with private health insurance obtain it through their employers. Thus, just as most do today, employers will pay most of the insurance premiums for their employees under the Act.

However, to ensure that the requirement to contribute to their employees' health insurance coverage is not too burdensome for employers, particularly small businesses, the Act generally limits each employer's obligation to a percentage of its payroll. The limit is 7.9 percent of total payroll, and is reduced for small firms with relatively low average wages to as little as 3.5 percent of total payroll. To the extent the employer's share of its employees' insurance premiums exceeds the percent-of-payroll limit, the federal government makes up the difference.

The obligation to pay a portion of the health insurance premiums is limited to the firm's employees. When a firm contracts for services from an individual independent contractor, the firm has no obligation to help pay for that individual's health insurance.[1] Rather, the individual, as a self-employed independent contractor, is required to obtain his or her own insurance. As a firm of one for this purpose, the individual may be entitled to a discount on the "employer" portion of the premium due to the percent-of-payroll limit applicable to small employers, depending on his or her income for that year.

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[1] Of course, if a firm engaged another firm to provide services to it, the individuals performing the services on behalf of the service-providing firm generally would not be considered employees of the first firm. Rather, the question of responsibility for contributing to the workers' health insurance would focus on the firm providing the services.

For these reasons, it is critical that workers be properly classified as employees or independent contractors. This requires that the classification rules be as objective as possible and, correspondingly, not subject to manipulation. One possibility for ensuring proper classification of workers for health care purposes would be to design a new definition of "employee" that would apply solely for purposes of the Act. However, the existing employment tax rules include a long-standing definition of employee which virtually all firms already apply. Adding a new, separate definition of employee for health care would unduly burden employers and workers by requiring them to make duplicative determinations of the status of every worker. Accordingly, the Act uses a single set of rules to determine the status of workers, based on the existing employment tax rules.

The existing employment tax rules are clear for the vast majority of firms and workers. However, the underlying common law standard for classification requires an analysis of the particular facts and circumstances of each firm/worker relationship, which can be quite subjective in certain situations. As a result, it has been criticized as imprecise, unpredictable, and subject to manipulation. In addition, current law may cause competitive distortions by permitting some employers to treat their workers differently from those of similarly situated competitors.

Fairness to the businesses and individuals who pay their appropriate shares of premiums under the Act requires that other employers not be allowed to escape their obligations to pay premiums by improperly reporting their employees as independent contractors. Similarly, businesses should not be allowed to abuse the percent-of-payroll limits by manipulating the firm's size and average payroll through misclassification of workers.

Because the existing rules work well for most firms and workers, however, there is no need or desire to make wholesale revisions to those rules in order to prevent gaming by some employers. Accordingly, the Act generally adopts the current employment tax rules for health care purposes. However, the Act also modifies the current rules in two respects, as described below, to prevent abuses in the health care system through misclassification of workers.

Consistent with the objective of preventing future manipulation of health care obligations through worker misclassification, these amendments are effective purely on a prospective basis. They do not affect the determination of workers' status for periods prior to the enactment of the Act. Furthermore, we believe that these prospective changes will not cause substantial reclassification of workers in the future from their current status under the existing employment tax rules. Rather, our goal is to prevent gaming of the system by developing fairer and more administrable classification rules without significantly affecting the outcome in relation to current law.

Discussion of Provisions

Definition of "Employee." The first modification of current law relates to the definition of "employee" in the Internal Revenue Code (the "Code"). Most workers are classified as employees or independent contractors based on the traditional common law test for determining the employer-employee relationship.[2] Under current law, this test focuses on whether the employer has the right to control not only the result of the services but also the means by which that result is accomplished. In an effort to administer this facts and circumstances standard better, the Internal Revenue Service (the "IRS") derived from the case law a list of 20 factors that should be considered, with more or less weight being accorded to particular factors depending on the factual context.

The common law control test is by its nature difficult to apply. Moreover, many of the 20 factors to be considered are subjective, and the weight to be accorded a particular factor or set of factors in a particular situation can be unclear. As a result, it is difficult in some cases for employers to determine with certainty the correct status of their workers under current law. Conversely, the uncertainty in application of the rules to certain workers potentially allows firms to misclassify workers where that would be advantageous. Such an advantage will be present under the Act, where employers who could potentially misclassify their employees as independent contractors might be able to avoid their obligation to pay premiums or to abuse the percent-of-payroll premium limits.

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[2] The Code contains special rules for classifying certain categories of workers. Briefly, these include mandatory independent contractor classification of certain licensed real estate agents, direct sellers, and sitting-service placement agents (sections 3506 and 3508 of the Code); and mandatory employee classification of corporate officers and certain agent or commission-drivers, life insurance salesmen, home workers, and traveling salesmen (section 3121(d) of the Code). The Act would not affect these special Code rules.

In order to prevent abuse of the health care system in this manner, the Act authorizes the Secretary of the Treasury to issue prospective regulations for determining the classification of workers whose status is determined currently under the common law standard. As noted above, the regulatory rules would not override those Code provisions that provide mandatory classification rules for various classes of worker.[3]

To minimize concerns that the regulations could disrupt existing worker classifications, the Act provides that the regulations must give significant weight to the traditional common law test under current law. Thus, while we believe that it is important to have the ability to modify the existing standard to some extent if necessary to achieve a more objective and administrable standard and, accordingly, one that will not be as susceptible to manipulation and abuse, we do not expect that the results under the regulations will differ significantly from thee results under the current common law control standard.

We welcome guidance from this Committee regarding appropriate parameters for the regulatory rules. We suggest that the appropriate place for guidance in developing the regulations will be in the legislative history of the Act, in recognition that it is difficult to have a specific "one size fits all" statutory definition applicable to the many varied existing worker relationships. In addition, we believe it is desirable to maintain the continued flexibility that regulatory authority affords in an area that is as complex and dynamic as the workplace, as opposed to specific statutory rules that cannot be as easily adapted to changing work environments.

In the same vein, the IRS, as part of its "Compliance 2000" initiative, currently is working on a cooperative basis with representatives of several industries that have had particular difficulty with worker classification issues, to develop guidelines for determining the status of workers in those industries. We believe that this effort has proven productive for both taxpayers and the IRS, and we anticipate that this work could serve as a useful model for developing clear and fair regulatory rules.

We are also committed to working extensively and openly with interested taxpayers and industry representatives to develop appropriate guidelines prior to enactment. In fact, over the past several months wee have met with many business and labor organizations and associations representing specific industries with an interest in worker classification issues to begin discussions regarding the new rules. We will continue to work with these and other interested parties throughout the legislative and administrative rulemaking process. This process will include meetings as we develop the proposed rules, followed by issuance of proposed regulations for comment and open hearings. The process will also include consultation with other interested agencies within the Administration in order that their expertise may be brought to bear on this complex matter.

Finally, the regulations will be effective no earlier than for periods beginning more than six months after the regulations are issued in final form. At the time the regulations are finalized, the Secretary will provide a report to Congress regarding the regulations. This should allow ample time for taxpayers and their advisors to analyze the final regulatory rules and to resolve any questions that they may have.

Section 530. The second change relating to worker classification concerns the special rules adopted to protect certain firms from the IRS reclassifying their workers as employees. Originally, these rules were enacted as a temporary measure in section 530 of the Revenue Act of 1978 (and thus are referred to as "section 530") in response to controversies that had developed between taxpayers and the IRS regarding retroactive reclassification of workers.

Section 530 prohibits the IRS on audit from correcting erroneous classifications of workers as long as the employer: (i) has consistently treated all workers with substantially similar positions as independent contractors, (ii) has filed all necessary returns (including information returns) on a basis consistent with that treatment, and (iii) had a "reasonable basis" for that treatment. A reasonable basis can include, but is not limited to, reasonable reliance on: (i) judicial precedent, published rulings, or private letter rulings or technical advice memoranda issued with respect to the taxpayer; (ii) a past IRS audit of the taxpayer—including an audit in which workers' classification was not reviewed—in which there was no assessment attributable to the classification of the worker or of workers holding substantially similar positions; and (iii) a long-standing recognized practice of a significant segment of the industry in which the worker was engaged.

By its terms, section 530 is controlling only for purposes of employment taxes and only with respect to the employer. In addition, section 530 does not apply to three-party arrangements involving technical service workers.

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[3] See footnote 2.

Section 530 was enacted as a one-year "stopgap" measure until Congress could devise a less contentious standard for classifying workers. It was extended several times and finally extended indefinitely in 1982. Since Section 530 prohibits the IRS from issuing any regulations or revenue rulings regarding the proper classification of workers, the IRS has not been able to issue any generally applicable guidance in this area for over 15 years.

As long as the underlying classification test is difficult to apply with certainty in certain cases, a provision similar to section 530 generally can serve a useful short-term function to the extent it protects taxpayers from large retroactive assessments. In the context of health care reform, however, section 530 in its current form could foster manipulation and abuse of both the requirement that employers pay a portion of their employees' health insurance premiums and the payroll-based premium discount rules.

For example, the fact that section 530 presently applies only to the hiring firms (and not to the worker) can create "whipsaw" situations. Thus, if current section 530 continued to apply after health care reform became effective, a firm could treat a worker as an independent contractor under the protection of section 530, and thus not pay the employer's share of the worker's health insurance premiums, while the worker claims to be an employee under the common law control standard, and therefore likewise refuses to pay the employer's share of the premiums.

Similarly, the section 530 safe harbors, while generally appropriate to protect reasonable taxpayers from large retroactive assessments, need to be updated and made consistent with the changes brought about by health care reform. For example, a prior audit of a taxpayer by the IRS on a specific income tax matter completely unrelated to employment taxes or the health insurance premium requirements would, under existing section 530, shield an employer indefinitely into the future. This future amnesty provision would be incomprehensible in the context of any other tax provision, and now could well encourage gaming of the health care system.

In addition, the permanent prohibition on guidance from the IRS, while perhaps understandable when section 530 was to apply for only one year, creates unnecessary confusion because it has seriously impeded the IRS's ability to convey its interpretation of the law to taxpayers in advance of an audit. This 15-year void in guidance also increases the risk of inconsistent application of the rules. Moreover, it prevents new industries from receiving IRS guidance and the certainty regarding their responsibilities that new businesses especially desire and deserve.

Finally, certain of the current section 530 requirements should be liberalized to make the provision more fair to taxpayers. Specifically, the current consistency and return-filing requirements of section 530 need to be modified and relaxed so as to: (i) allow firms to reclassify workers prospectively as employees without fear that the reclassification could eliminate the section 530 protection for the firm's prior treatment of the worker as an independent contractor, and (ii) extend protection to taxpayers that inadvertently make only minor information-reporting errors.

Thus, the Act codifies section 530 in order to retain the benefits appropriately extended to most employers, but with modifications to address the problems that could arise with, or are magnified as a result of, health care reform. To ensure that the employer premium obligation is applied fairly, section 530's protective rules as modified would be extended to all firms, including three-party arrangements involving technical service workers. In addition, to avoid potential "whipsaw" situations, the determination of a worker's status under the modified rules would be controlling for both the firm and the worker.

Under the modified rules, the IRS would be permitted to reclassify misclassified workers on a *prospective* basis only. Moreover, as under existing section 530, the employer would be protected from retroactive reclassification if the employer met certain requirements.[4] These requirements would be generally the same as under existing section 530, with the following modifications:

Consistency and return-filing requirements. The consistency and return-filing requirements of section 530 would be essentially retained, but would be relaxed to address the overly stringent limitations described above. Thus, firms could reclassify workers as employees if appropriate without jeopardizing section 530 protection for treating the worker as an independent contractor in prior periods, and they would not lose section 530 protection if they inadvertently made minor information-reporting errors. This change will help provide consistent protection under the provision for similarly situated employers.

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[4] As explained below, if an employer were protected from reclassification of a worker under existing section 530 but would not be protected under the modified rules, and that worker were later determined to be properly classified as an employee, the reclassification of that worker could be made effective no earlier than for the first open period beginning after 1995.

Safe harbor requirements. The specific "reasonable basis" safe harbors of section 530 also would be largely retained, but would become the exclusive safe harbors under the provision. These safe harbors would be modified as follows to prevent possible abuse and to accommodate the future adoption of a revised regulatory "employee" definition.

Under the "prior precedent" safe harbor, reliance on written determinations (i.e., private letter rulings, etc.) issued by the IRS with respect to the taxpayer would not be changed. Reliance on other authorities would have to meet the "substantial authority" standard now required of all taxpayers to avoid penalties for substantial understatement of income taxes. This standard does not require that the preponderance of authority support the taxpayer's classification of the worker, but it does require the taxpayer to give some weight to authorities, if any, that do not support the taxpayer's position. Consistent with the application of this standard, the types of authorities to be considered would be expanded (from judicial precedent and IRS revenue rulings) to include any item that is "authority" under the "substantial authority" standard, other than private letter rulings issued to other taxpayers (as under current law). This includes, for example, legislative materials, final and temporary Treasury regulations, and IRS revenue procedures, notices, announcements, press releases, and other official pronouncements.

The "prior audit" safe harbor would be limited to audits in which the employment status of the worker (or similar workers) was actually reviewed. This limitation is important to eliminate the ironic "lottery" aspect of the current rule, under which a taxpayer can obtain blanket acceptance of its worker classifications by the fortuitous occurrence of an IRS audit in which the examining agent did not review, or even consider, the taxpayer's treatment of its workers. Moreover, to reflect the repeal of the prohibition of IRS guidance on worker classification issues, the Act also provides that if the IRS issues general classification guidance (such as a revenue ruling under the common law control test or the revised regulatory definition) after the relied upon audit, then, as to the workers covered by that guidance, the firm would no longer be permitted to rely on that prior audit for periods following the issuance of such guidance.

Taxpayers could continue to rely on the existing "industry practice" safe harbor until a regulatory definition of employee is issued (or guidance is issued by the IRS under the common law control test addressing workers in that industry). However, we expect the regulations generally to be consistent with existing industry practices that are based on reasonable applications of the existing common law control test.

The codification of, and modifications to, section 530 will be effective for periods after 1995, except that the IRS will be able to issue guidance of general applicability regarding worker classification issues under the existing common law standard any time after enactment of the Act. Thus, for example, if a taxpayer were protected from reclassification of a worker under current section 530, but would not be protected under the modified rules, any reclassification of that worker could apply no earlier than the first open period beginning after 1995. If the IRS issued a revenue ruling addressing the status of a type of worker under the existing common law standard in 1995, that ruling could not be applied for any period prior to the date of enactment of the Act.

B. Increased Reporting Penalties For Service Payments

The Act generally limits the aggregate amount a firm must pay towards its employees' health insurance premiums to a percentage of the firm's total payroll, with that percentage varying based on the number of employees and their average wages. For purposes of this computation, the Act treats a self-employed individual as his or her own employee and treats his or her earnings as wages. In general, the individual's income tax return will provide the earnings information. It is, therefore, essential that a worker who performs services as an independent contractor (correctly classified or not) properly report all of his or her service-based income for tax purposes in order to apply the premium discounts to such workers accurately.

Under current law, service-recipients are required to file an information return—a Form 1099—that reports payments made to any individual independent contractor that exceed $600 during a calendar year. This information-reporting system is one of the most effective tools for enforcing complete reporting of income by independent contractors, because taxpayers are demonstrably more likely to report a payment on their income tax return if they know the payment already has been reported to the IRS by the payor.

The penalty on the service-recipient for failure to file the information return, however, is only $50 (unless the failure is due to intentional disregard of the reporting

requirement, as discussed below). We believe this relatively minor penalty, last increased in 1982, contributes to the existing problem of substantial noncompliance with these reporting requirements. Many experts in this area have proposed in recent years substantially increasing this penalty. With the additional reliance the health care system will place on proper reporting of service-based income, we believe that the penalty must be increased in order to guard effectively against abuse.

The Act increases the penalty for failure to report payments for services performed by non-employees to the greater of $50 (the current penalty) and 5 percent of the amount not properly reported. Increasing the penalty in proportion to the amount of the unreported payment balances the need to have a stronger incentive to comply with the reporting rules with the concern that the penalty not be unduly harsh.

Under current law, the $50-per-failure penalty is reduced or waived under certain circumstances and, unless the failure is due to intentional disregard, is subject to aggregate annual limits. For example, the maximum aggregate annual limit is $250,000. If the taxpayer files the correct returns after the prescribed due date but on or before August 1, the per-failure penalty is reduced to $30 and the aggregate annual limit is reduced to $150,000. If the taxpayer files the correct returns late but within 30 days after the prescribed filing date, the per-failure penalty is reduced to $15 and the aggregate annual limit is reduced to $75,000. These aggregate annual limits are reduced further fore certain small businesses. In addition, if the taxpayer timely filed all returns but was required to file corrected returns for a de minimis number of those returns, and the corrected returns were filed before August 1, the penalty with respect to those incorrectly filed returns would be waived. Finally, under existing law, the penalty may be waived if the taxpayer demonstrated that the failure to file the returns was due to "reasonable cause."

To ensure that the new 5 percent penalty will not be imposed in instances of minor or extremely infrequent failures to file, these provisions of current law will continue to apply. Thus, for example, if a taxpayer discovered in June that he or she inadvertently failed to file a few returns or made errors in returns that were timely filed, and those failures or errors were corrected prior to August, the penalty would be no more than $30 per return, and may be waived entirely if, for example, fewer than 10 returns were corrected in this manner.

In addition, the aggregate annual limits under current law will be retained to ensure that, even if a firm has substantial noncompliance, the aggregate penalty will not exceed certain amounts. We felt that retention of the existing caps was not likely to dampen the incentive effect of the increased penalty.

The Act adds one final limitation on the new increased penalty to ensure that the increase will not be imposed on those firms that have very substantially complied with the reporting requirements, indicating that the failure is likely due to inadvertence or administrative error in a firm that has made a serious attempt to fully comply with the rules. Specifically, the new limitation provides that the penalty will be limited to $50 per failure, as under current law, if the taxpayer properly reported at least 97 percent of all such amounts required to be reported for that period.

As under current law, the penalty is increased to the greater of $100 and 10 percent of the unreported (or incorrectly reported) payment, and the annual dollar limitations described above are waived, if the failure to report is due to intentional disregard. This increase, which is double the $50 or 5 percent penalty under the Act, was thought to be sufficient penalty for those who choose simply to ignore these rules.

The Act does not change the penalty for failure to provide a copy of the information return to the payee, which currently is also $50 per failure ($100 or 10 percent of the amount if due to intentional disregard). Since in most instances a firm that does not file the information return with the IRS is not likely to provide a copy of that return to the payee, increasing this penalty as well would be equivalent to doubling the penalty, which we believe would be excessive. Instead, we believe that, dine virtually all cases, a firm that files the information return with the IRS also provides a copy to the payee as a matter of course. Accordingly, we believe it is appropriate to focus the increased penalty on the requirement to file the return with the IRS.

This increase in the reporting penalty has been crafted to give a stronger incentive to firms to report payments made to non-employees for services rendered, but with ample protection to ensure that firms that generally comply with the rules will not be subject to disproportionately high penalties for relatively minor or few failures. In this way, we protect the health care system from abuse without substantial risk of excessive penalties in any particular situation.

II. CHANGES IN EMPLOYMENT TAX RULES RELATING TO S CORPORATIONS AND LIMITED PARTNERS

As another anti-abuse measure, the Act revises certain employment tax provisions relating to S corporation shareholders and limited partners. Under current law, S corporation shareholders are subject to employment tax under the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA"), but only to the extent the S corporation characterizes payments to the shareholder-employee as wages. In contrast, general partners and sole proprietors are subject to employment tax on all of their "net earnings from self-employment" under the Self Employment Contributions Act of 1954 ("SECA"), with certain exceptions. Limited partners pay SECA tax only on guaranteed payments made to them in exchange for services.

As noted above, the Act requires every employer to pay a share of his or her employees' health insurance premiums, subject to discounts based on the firm's payroll and number of employees. We believe that, to minimize the administrative and compliance burdens on firms and to avoid the creation of an additional unfamiliar set of rules, the computation of "wages" paid to the firm's employees, for purposes of determining the firm's payroll-based premium discounts, should rely generally on the existing employment tax rules which all firms already must apply. (This is consistent with the approach we have taken with the definition of "employee," as discussed above.) For this purpose, the "net earnings from self-employment" of owner-employees is also treated as "wages."

The existing tax rules, however, can be manipulated, potentially allowing firms to exploit the payroll-based premium discount rules improperly. For example, by treating compensation for services as non-wage distributions, an S corporation and its shareholders could attempt to reduce the firm's payroll, thereby allowing the S corporation to obtain greater premium discounts. Limited partners who materially participate in a partnership could similarly disguise compensation for services as non-wage distributions. The rules for similarly situated general partners and sole proprietors do not permit wages to be disguised in this manner.

To provide one consistent set of rules for health care and employment tax purposes for all firms, we propose generally to follow the existing employment tax rules in determining "wages" for health care purposes. However, to avoid abuse of those rules in determining eligibility for health care premium discounts, we propose to modify the rules for both health care and employment tax purposes.

Under the Act, any individual who owns more than two percent of the stock of an S corporation that has a service-related business and who materially participates in the business conducted by the S corporation would be treated as having "net earnings from self-employment" equal to his or her distributive share of the S corporation's income from the service-related business. Existing exceptions to this treatment for partnerships would also generally apply for S corporations to the extent they are appropriate. Payments to shareholders that are designated as wages would continue to be subject to FICA and FUTA. In this manner, all service-related earnings of two-percent S corporation shareholders who materially participate in the corporation's business would be treated as "wages" in determining the corporation's eligibility for premium discounts. This rule would apply regardless of when and in what manner the earnings are paid to the shareholders (i. e., as wage payments or shareholder distributions).

The definition of service-related business we adopted is based on the small business capital gain exclusion provision in the Omnibus Budget Reconciliation Act of 1993. We believe this provides a reasonably administrable rule.

Material participation is a term already used in the SECA tax provisions as well as elsewhere in the Code. Treasury regulations under these provisions provide further guidance to determine when a taxpayer's involvement constitutes material participation. These rules will provide a foundation on which to base the proposed material participation standard for determining health care wages.

To address the same concern in the context of limited partnerships, we would treat any individual limited partner who materially participates in the partnership's activities as having "net earnings from self-employment" equal to his or her distributive share of partnership income. In this manner, the individual limited partners' earnings from the partnership would be treated as "wages" for purposes of determining the partnership's eligibility for premium discounts.

III. TAX TREATMENT OF NONPROFIT HEALTH CARE ORGANIZATIONS

Current Law

Nonprofit Hospitals. In a 1956 revenue ruling, the IRS held that a nonprofit hospital did not qualify for tax exemption as a charitable organization described in sec-

tion 501(c)(3) of the Code unless the hospital, to the extent of its financial ability, provided care to those unable to pay the cost of the care. Rev. Rul. 56-185, 1956-1 C.B. 202. This ruling was based on the view that section 501(c) (3) of the Code used the term "charitable" in the popular sense of providing relief to the poor. Regulations issued in 1959, however, provide that section 501(c)(3) of the Code uses the term "charitable" in its broader common law sense. Under the common law concept, charity is not limited to the relief of the poor. In particular, the promotion of health is a separate charitable purpose under common law.

Based on the 1959 regulations and on the expanding role of governmental and private health insurance, the IRS issued Revenue Ruling 69-545, 1969-2 C.B. 117, which is the source of the "community benefit" test that governs the qualification of hospitals for tax exemption today. Revenue Ruling 69-545 modified the earlier 1956 ruling to remove the requirement that a tax-exempt hospital provide charity care to the extent of its financial ability. Revenue Ruling 69-545 held that a hypothetical hospital qualified for tax exemption under section 501(c) (3) of the Code because it "promot(ed) the health of a class of persons broad enough to benefit the community" and was operated to serve a public rather than private interest.

Health Maintenance Organizations. A nonprofit health maintenance organization ("HMO") that provides health services predominantly at its own facilities through the use of its own staff may qualify as a tax-exempt charitable organization under the same standards that govern nonprofit hospitals. *Sound Health Association* v. *Commissioner,* 71 T.C. 158 (1978). By contrast, an HMO that does not provide health care services itself may be denied exemption as a charitable organization under section 501(c) (3) of the Code. *Geisinger Health Plan* v. *Commissioner,* 985 F.2d 1210 (3d Cir. 1993). A non-provider HMO may qualify for exemption, however, as a social welfare organization described in section 501(c) (4) of the Code. Section 501(c) (4) of the Code exempts from tax civic leagues or organizations not operated for profit but operated exclusively for the promotion of social welfare.

Section 501(m) of the Code disqualifies an organization from exemption under section 501(c)(3) or 501(c)(4) of the Code if it provides "commercial-type insurance" as a substantial part of its activities. The definition of commercial-type insurance does not include incidental health insurance of a type customarily provided by an HMO.

Section 501(m) of the Code was enacted in 1986 in part to disqualify Blue Cross/Blue Shield organizations from tax exemption. Thus, Blue Cross/Blue Shield organizations are generally treated as taxable property/casualty insurance companies. With the enactment of section 501(m) of the Code, however, Congress enacted two special rules that provide favorable treatment to Blue Cross/Blue Shield organizations. Section 833 of the Code provides that these organizations are (1) entitled to a special tax deduction, equal to the amount by which 25 percent of their health claims exceeds their adjusted surplus, and (2) exempt from a requirement that property/casualty insurers include in taxable income 20 percent of the change in their unearned premium reserves.

Current law provides special rules for calculating the taxable income of insurance companies. These rules allow a taxable insurance company to deduct estimates of claims that are incurred but not reported and reserves for unpaid losses. The insurance rules override the general rule that expenses are not deductible until the occurrence of all events necessary to fix and determine the taxpayer's liability. It is unclear whether HMOs that are subject to tax may use the special rules applicable to insurance companies in computing their tax liabilities.

Discussion of Provisions

Nonprofit Health Care Providers. Under the Act, hospitals and other nonprofit health care providers will continue to be eligible for tax exemption, as they have since the very beginning of our income tax system. Although the Act does not deny tax exemption to nonprofit health care providers, it does add a new requirement that a provider must meet, in addition to the community benefit test of current law, to qualify for tax exemption under section 501(c)(3) of the Code. To meet this new requirement, the provider must assess the health needs of its community at least annually and develop a plan to meet those needs. The provider will have to conduct this needs assessment and plan development process with the participation of community representatives. The needs assessment and plan development requirement is intended to apply to any organization that seeks to qualify as a tax-exempt charitable organization by reason of its provision of health care treatment to patients, including, for example, clinics, nursing homes and home health agencies.

Nonprofit hospitals and other health care providers should earn tax exemption by providing services that meet the needs of their communities. The community benefit test of current law provides some assurance that tax exemption is granted only to deserving nonprofit providers. The needs assessment and plan development require-

ment included in the Act will provide further assurance that tax-exempt providers are responsive to needs of their communities and therefore are worthy of tax exemption.

The needs assessment and plan development process contemplated by the Act may be best understood by reference to a hypothetical example. This example illustrates one process that would meet the new requirement. A health care provider need not follow the particular procedures described in the example, however, to meet the requirement. Other procedures that allow a provider's community a meaningful opportunity to participate in the development of the provider's programs would also meet the requirement.

> *Example.* Hospital A is a private, nonprofit hospital located in a large, urban area. The Board of Trustees of Hospital A adopted a mission statement that declares the hospital's commitment to implement and conduct a community benefit program. Hospital A's Chief Executive Officer ("CEO") is responsible for the overall management of the community benefit program. The CEO directs the hospital's Planning and Community Relations Departments to study the health needs of the locality served by the Hospital.
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> The Planning Department obtains statistics on morbidity and mortality. The Community Relations Department establishes a Community Advisory Board, which includes representatives of several community organizations. Among the organizations represented are the county health department, several local charitable organizations, the Chamber of Commerce, a senior citizens' organization, the local public schools, a number of religious organizations, and a few large employers who operate facilities within Hospital A's service area. Personnel from the Community Relations and Planning Departments meet with the Community Advisory Board to discuss the area's health needs.
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> The Planning Department then prepares a draft report that describes the most significant health needs of the community. The report, for example, refers to the large population of homeless persons in the community who have inadequate access to health care services. The report also discusses increasing rates of pregnancy among drug-addicted teenager. The Community Advisory Board meets to discuss the draft report on community health needs. The Planning Department takes into account the comments of the Community Advisory Board in preparing a final report.
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> The Planning Department, in consultation with the Community Advisory Board, considers various means of addressing the community health needs identified in the report. The Planning Department works with the hospital's Finance and Budget Departments to estimate the costs of these various programs. Then, representatives from these three departments meet with the Community Advisory Board to select new programs to be implemented to address the community's health needs. These programs are selected on the basis of the urgency of the need, the cost of the program, the financial resources of the hospital, and the potential contributions to the program by other community organizations. Those programs selected are identified in a draft community benefit plan.
>
> The draft community benefit plan includes a counselling program for drug-addicted teenage mothers, to be run in cooperation with public school counsellors, social workers, and a local job placement agency. The plan also includes an outreach program to address the needs of the homeless. Hospital A will participate in this program with the housing authority of the local government and several local charitable organizations. The program will provide opportunities for shelter, as well as transportation to food service facilities and a health clinic to be operated by Hospital A. The clinic will provide preventive care treatment, including nutritional counselling. The draft plan includes objectives for each program to measure its progress over time. The plan is then finalized with the approval of the CEO and the Board of Trustees.
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> The Community Relations Department reports to the Community Advisory Board periodically regarding Hospital A's implementation of its community benefit plan.

The needs assessment and plan development requirement is intended to be flexible. Flexibility is an important criterion in considering the standards for tax exemption of nonprofit health care providers because of the wide variety of these organizations, the diverse needs of the communities in which they operate, and the changes in the marketplace expected to result from health care reform. In particular, the tax laws should not impede the ability of health care providers to engage in community outreach, providing the type of preventive and community-based services that will help control health care costs while meeting community needs. Detailed, specific

standards might fail to take into account all of the facts and circumstances that might bear on an organization's qualification for tax exemption.

Many programs being conducted by health care providers today illustrate the variety of health needs of different communities, and the unique means by which providers are meeting those needs. For example, a group of health care providers in Chicago has established a program to meet the needs of that city's population of Russian Jewish immigrants. Special clinics have been established to meet the health needs of these persons. The program also includes outreach activities to address language and cultural differences. Other communities may have different groups with specific needs. For example, a New Jersey hospital located in an area with a large elderly population has established a center for geriatric health. The center offers a wide range of services, including adult day care for frail and impaired seniors. The center also arranges laundry and other services to enable seniors to live independently at home.

These are just a few examples of the many ways in which health care providers may respond to the unique needs of their communities. The needs assessment and plan development requirement included in the Act, together with the community benefit test of current law, will provide assurance that tax-exempt providers meet the needs of their communities.

The hallmark in determining whether the needs assessment and plan development requirement is met will be whether the community has been provided a meaningful opportunity to participate in the development of the provider's programs. The identity of the relevant community and appropriate persons to represent the community will depend on the facts of each case. For example, the community served by a provider of specialized care would not be defined on the basis of location, but would include all persons in need of that type of care.

Because of the wide variety of community needs, the community representatives will be in the best position to judge the adequacy of a plan developed to meet those needs. Thus, the IRS will not be required to judge the adequacy of a plan. To meet the needs assessment and plan development requirement, the provider will have to take into account any concerns expressed by the community representatives regarding the adequacy of the plan. The provider will have to include in the plan measures to meet these concerns, or have a reasoned explanation for a failure to include these measures.

A failure by a provider to implement a plan developed to meet community needs may call into question whether the community has been meaningfully involved in determining the provider's programs, and, therefore, whether the needs assessment and plan development requirement has been met. Similarly, a failure to report to the community on the implementation of the plan, or otherwise provide community representatives the ability to monitor implementation, may call into question whether the provider has afforded the community the meaningful involvement contemplated by the new requirement. However, a provider that does not fully implement every element of a plan will not necessarily jeopardize its tax exemption.

Current law does not require the provision of a particular amount of charity care as a condition of tax exemption. Because the President's health care reform plan will provide health coverage to all Americans, the Act also does not include provisions relating specifically to charity care.

The achievement of universal coverage, and resulting elimination of the need for charity care, does not mean that the activities of nonprofit health care providers will be indistinguishable from those of for-profit providers. For-profit providers seek to maximize their profits for the benefit of their owners. Thus, for-profit providers may have little incentive to engage in activities other than treating fee-paying patients. By contrast, nonprofit providers do not face the same "bottom line" pressure. Therefore, nonprofit providers generally provide services to the community in addition to the treatment of fee-paying patients. Treating patients who are unable to pay the cost of the care is only one type of additional service that nonprofit providers offer today. Others include medical research, education programs, health screening, immunization, preventive care, and outreach programs. As noted above, these preventive, community-based services are important to meet community needs and achieve control over health care costs.

Health Maintenance Organizations. Health care organizations may be arrayed on a continuum, with pure providers, such as hospitals, at one end and traditional indemnity insurers at the other. HMOs, preferred provider organizations and other hybrid organizations lie between these two extremes. Differences among the organizations revolve around the extent to which an organization is involved in treating patients, the extent to which an organization shifts to providers the risk of loss from utilization of health care services, whether an organization operates on a nonprofit basis, and the extent of community benefit an organization provides. The continued

eligibility of hospitals for tax exemption and the continued imposition of tax on indemnity insurers requires a line to be drawn somewhere along the continuum of health care organizations to separate those that can qualify for exemption from those that cannot. As explained below, the Act draws a rational line on the basis of meaningful distinctions between the affected organizations.

The Act provides rules that distinguish between taxable insurance companies and HMOs that may qualify for tax exemption. The rules accomplish this result by classifying certain forms of insurance provided by an HMO as commercial-type insurance. As noted above, section 501(m) of the Code denies tax-exempt status to an organization that provides commercial-type insurance as a substantial part of its activities. The classifications made by the Act are consistent with the IRS's current interpretation of section 501(m) of the Code.

The Act specifies that insurance provided by an HMO related to four types of health care treatment is not commercial-type insurance: (1) treatment provided by an HMO at its own facilities by its own staff, as is characteristic of "staff" or "group" model HMOs; (2) primary care provided by a health care professional who is paid by the HMO on a fixed or "capitated" basis, so that the amount paid to the provider does not vary with the amount of care provided; (3) services other than primary care, such as hospital or specialty services, provided within the HMO's provider network; and (4) emergency care provided to a member of the HMO outside the member's area of residence.

A nonprofit HMO will continue to qualify for tax exemption under the Act only if its activities may be meaningfully distinguished from the provision of traditional, fee-for-service indemnity insurance. In this regard, the provisions of the Act look to two key factors: (1) the degree of involvement by the HMO in the treatment process, and (2) the manner in which the HMO pays the health care professionals who provide treatment.

A nonprofit HMO that directly provides health care treatment to its members more closely resembles a hospital or clinic than a traditional fee-for-service indemnity insurer. Therefore, under the Act, such an HMO, regardless of whether it is paid as services are rendered or on a prepaid basis, may qualify for tax exemption under section 501(c) (3) of the Code—the provision that applies to hospitals and clinics.

An HMO that does not operate its own hospitals or clinics may still be significantly more involved in the treatment process than a traditional fee-for-service indemnity insurer. The HMO may have pre-existing contractual relationships with the physicians who provide treatment. Further, the HMO may use "gatekeepers," generally primary care physicians, who control the members' access to hospital and specialty care. A nonprovider HMO may be further distinguished from a traditional fee-for-service indemnity insurer if it pays on a fixed or capitated basis those health care professionals who provide care to its members. Such a capitation arrangement essentially "shifts" to the providers much of the risk regarding utilization of services. The HMO will pay a provider the same amount for each member enrolled with the provider, regardless of the amount of care required by the member. Although the HMO may be providing "insurance" in a technical sense, the shifting of risk to the provider makes the arrangement distinguishable from traditional, fee-for-service indemnity insurance. Therefore, under the Act, a nonprofit, non-provider HMO may qualify for tax exemption if its members receive hospital and specialty care from providers with pre-existing contractual relationships with the HMO and if access to this care is controlled by primary care gatekeepers paid by the HMO on a fixed or capitated basis.

Consistent with current case law, the Act would allow these nonprofit, non-provider HMOs to qualify for tax-exemption under section 501(c)(4) but not section 501(c)(3) of the Code. A non-provider HMO is not sufficiently similar to a hospital or clinic to warrant exemption under section 501(c)(3) of the Code. Further, the principal federal tax benefits to an HMO of qualifying for exemption under section 501(c)(3) instead of section 501(c)(4) of the Code relate to the availability of subsidized sources of capital. An organization described in section 501(c)(3) may receive tax-deductible contributions and tax exempt bond financing, while an organization described in section 501(c)(4) cannot. A non-provider HMO, however, has significantly lower capital needs than an HMO that must purchase the facilities and equipment to provide health treatment. Therefore, there is less justification for allowing non-provider HMOs to receive financing from subsidized sources such as deductible contributions and tax-exempt bonds.

The Act classifies "point of service benefits" as commercial-type insurance. Point of service benefits allow a member of an HMO to obtain treatment outside the HMO's provider network. The HMO pays the cost of the care in excess of deductible and co-payment amounts for which the member is liable. Because these benefits are

essentially traditional, fee-for-service indemnity insurance, the IRS, in applying section 501(m) of Code, treats these benefits as commercial-type insurance. The Act would codify this position.

To maximize the choices available to consumers, the President's health care reform plan will require HMOs to provide point of service benefits to their members so that members can seek care outside the HMO's provider network. As just noted, however, these benefits are commercial-type insurance. Therefore, an HMO would not be entitled to tax exemption if the provision of point of service benefits were a substantial part of its activities.

Some HMOs have expressed concern that their tax exemption could be jeopardized by a factor outside their control: the extent to which their members elect to receive point of service benefits. We appreciate these concerns and agree that an HMO should not be unreasonably at risk of losing its tax exemption because it provides point of service benefits as required by the President's plan. We are working to develop appropriate measures to address this potential problem and would welcome comments from the Committee and interested persons in resolving this issue.

In addition, the Act provides rules under which a nonprofit HMO that does not qualify for tax exemption will be entitled to compute its taxable income using the provisions applicable to insurance companies. Thus, for example, taxable HMOs will be allowed to deduct estimates of claims that are incurred but not reported and reserves for unpaid losses. However, an HMO that directly provides health care treatment to its members generally would not record claim reserves because health care services are rendered directly.

HMOs that operate on a for-profit basis would be taxed as insurance companies regardless of how providers are compensated. Because many HMOs pay some providers on a capitated basis and other providers (e. g., specialists) on a fee-for-service basis, determining tax treatment based on the relative amounts of capitated and fee-for-service payments would be impractical and administratively difficult. While all taxable HMOs would be treated as insurance companies, the application of the insurance accounting rules under subchapter L of the Code would produce different results depending on the type of HMO, as mentioned in the previous paragraph.

Blue Cross/Blue Shield Organizations. The Act will eliminate the special deduction for Blue Cross/Blue Shield organizations and require these organizations to include in income 20 percent of the change in their unearned premium reserves, in the same manner as other taxable insurance companies. The Act also includes transition rules that phase in the effects of these changes.

The special deduction for Blue Cross/Blue Shield organizations provided a subsidy to these organizations in recognition of the benefits resulting from their practice of charging community-rated premiums and not excluding from coverage those with pre-existing medical conditions. The Act, however, will prevent all insurance companies from denying coverage on the basis of health, employment or financial status. Further, the Act will effectively require all plans receiving premiums through health alliances to charge community-rated premiums. Therefore, providing a subsidy to Blue Cross/Blue Shield organizations will no longer be necessary to ensure that members of the public are able to obtain insurance with community rated premiums.

The exemption of Blue Cross/Blue Shield organizations from the requirement to include in income 20 percent of the change in their unearned premium reserves was designed to ease the transition of these organizations from tax-exempt to taxable status. These organizations, however, have now been subject to tax for several years. Therefore, the need for transition relief has passed.

Intermediate Sanctions and Health Care

An organization qualifies for tax exemption under section 501(c)(3) of the Code only if no part of its net earnings inures to the benefit of any private shareholder or individual. Under current law, revocation of an organization's tax exemption is the sole sanction available for violations of the inurement prohibition or other standards for exemption. The absence of a sanction short of revocation causes the IRS significant enforcement difficulties. Because revocation is a severe sanction, it may be disproportionate to the violation in issue. Under current law, however, the IRS faces the difficult choice of revoking an organization's exemption or taking no enforcement action.

At a hearing before the Ways and Means Subcommittee on Oversight on March 16, 1994, the Administration presented proposed intermediate sanctions, short of revocation, that would apply to violations of the standards for tax exemption. Included among the Administration's proposals is an excise tax on "insiders" of an organization exempt from tax under section 501(c) (3) or 501(c) (4) who receive benefits from the organization to which they are not entitled. In particular, the tax

would apply to payments of unreasonable compensation and non-fair market value transfers in which the insider pays too little for property transferred by the organization or the organization pays too much for property transferred by the organization. Our proposed excise tax would deter insiders of tax-exempt health care organizations, including HMOs exempt from tax under section 501(c) (4), from taking advantage of the expected restructuring of the health care market to divert to their own benefit resources of the organizations.

IV. TAX TREATMENT OF EMPLOYER-PROVIDED HEALTH CARE

The Act contains a number of interrelated provisions pertaining to the tax treatment of employer-provided health care. These provisions work together to enhance cost consciousness on the part of individuals, while building on our current employer-based health care system. Before summarizing these provisions and their rationale, I will review briefly the tax treatment of employer-provided health care under current law.

A. Limitations on the Exclusion for Employer-Provided Health Coverage and Health Benefits Under Cafeteria Plans

Current Law

Under section 106 of the Code, an employee's gross income does not include employer-provided coverage under an accident or health plan. Benefits an employee receives under an employer-provided accident or health plan generally are excludable from gross income under section 105 of the Code if they are reimbursements to the employee for medical expenses. However, if the employer's plan is a self-insured medical reimbursement plan, the exclusion will not apply to certain reimbursements under the plan unless the plan meets statutory nondiscrimination requirements.

Compensation generally is includable in gross income when it is actually received or constructively received. In general, an individual is in constructive receipt of compensation when it is made available to the individual or when the individual can obtain the amount by giving notice of intent to do so. Accordingly, in the absence of the special rules for cafeteria plans under section 125 of the Code, an employee's right to choose between cash and excludable accident or health coverage generally would result in an inclusion in income of the amount of cash that is available to the employee. However, a cafeteria plan that satisfies certain nondiscrimination and other requirements under section 125 may offer employees such a choice without causing them to be in constructive receipt of the cash.

A flexible spending arrangement ("FSA") generally is an account or other benefit program that provides employees with coverage that reimburses them for specified health care expenses or other nontaxable employer-provided benefits. An FSA may be included in a cafeteria plan (in which case it is subject to the cafeteria plan requirements) or may be provided to employees outside of a cafeteria plan. In addition, in the case of an FSA that provides health benefits and that is described in proposed Treasury regulations, whether or not it is part of a cafeteria plan, the coverage and reimbursements under the FSA will be excludable from income only if the FSA satisfies additional requirements prescribed by the proposed regulations.

In general, employers are permitted to deduct, as an employee compensation expense, the entire cost of health insurance coverage provided for their employees.

Discussion of provisions

Under the Act, the unlimited exclusion for employer-provided coverage under an accident or health plan, including coverage under an FSA, will be limited to coverage consisting of the guaranteed comprehensive benefit package described in the Act, as well as cost-sharing amounts (deductibles, copayments and coinsurance) under the comprehensive benefit package and certain "permitted coverage." After the applicable effective date, other employer-provided health care coverage (generally referred to in the Act as coverage for "supplemental" health benefits) will be includible in gross income and in wages for income tax and employment tax purposes.

The exclusion for employer coverage of cost-sharing amounts under 'the comprehensive benefit package applies also to employer contributions to coverage under a health insurance plan or policy that provides coverage for such cost-sharing. "Permitted coverage" is defined under the Act to include (I) any coverage providing wages or payments in lieu of wages for any period during which the employee is absent from work on account of sickness or injury; (ii) any coverage providing payments for the permanent loss or loss of use of a member or function of the body, if the payment is computed with reference to the nature of the injury without regard to the period the employee is absent from work; (iii) any coverage provided to an

employee or former employee after age 65, if the coverage is not provided by reason of the individual's current employment with the employer providing the coverage; (iv) any coverage under a qualified long-term care insurance policy (as defined in the Act); (v) any coverage provided under Federal law to members of the Armed Forces or veterans and their spouses and dependents, and (vi) any other coverage to the extent the Secretary of the Treasury determines that an exclusion for such coverage is not inconsistent with the purposes of the limitation on the exclusion.

If an employee received employer-provided coverage that was not excludable, the amount of income includible in the employee's gross income would be based on the average cost of providing the coverage to those who receive it. To the extent provided by the Secretary of the Treasury, these cost determinations could be made on the basis of reasonable estimates.

The current-law exclusion for amounts received under an employer-provided accident or health plan is not modified by the Act, nor is the employer's tax deduction for contributions to an accident or health plan.

The Act eliminates the ability of a cafeteria plan (including an FSA) to offer employer-provided accident and health coverage on a pre-tax basis. This rule will not apply, however, to coverage providing wages or payments in lieu of wages for any period during which the employee is absent from work on account of sickness or injury. In addition, the Act will not eliminate the ability of a cafeteria plan under current law to offer other employer-provided nontaxable benefits (such as dependent care or group life insurance).

The limitation on the exclusion for employer-provided coverage generally would be effective January 1, 2004, but the limitation would be effective January 1, 1997 in the case of employer-provided coverage provided through an FSA. The Act defines an FSA as a benefit program that provides employees coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and other reasonable conditions) and under which the maximum amount of reimbursement that is reasonably available to a participant for the coverage is less than 200 percent of the value of the coverage. The provision affecting the tax treatment of employer-provided accident and health benefits or coverage under a cafeteria plan will be effective January 1, 1997.

One of the fundamental goals of health care reform is cost containment. The rate of increase in health care costs can be slowed by making individuals and employers more cost conscious. Yet the current unlimited exclusion for employer-provided health coverage gives employers and employees an incentive to allocate a larger portion of the total compensation package to the purchase of additional tax-favored health coverage instead of taxable wages. By reducing the effective price of the coverage, this tax subsidy tends to increase the amount of coverage employers and employees purchase, including various "supplemental" benefits that are not included in the guaranteed comprehensive benefit package. Eliminating the exclusion for this supplemental coverage will mean that coverage will be purchased with after-tax dollars; and as employees become more aware of the true cost of supplemental benefits, they can be expected to reduce their demand for those benefits and purchase less.

The prohibition on the provision of health coverage under cafeteria plans and the limitation on FSAs will eliminate employees' ability to pay for additional health coverage on an individual, discretionary basis with pre-tax dollars. Proponents of continuing the current tax-favored treatment of cafeteria plans emphasize that cafeteria plans offer employees choice: between cash and health benefits or among different types or levels of health benefits or coverage. However, under the Act, the most important choices—among types of health coverage, health plans, and providers—are built into the new system, within the framework of universal private insurance coverage through a guaranteed comprehensive benefit package. All Americans will be guaranteed these basic choices, including choices among higher and lower cost-sharing plans, which frequently are options offered under a cafeteria plan.

The Act provides these choices without the inequities in the Federal tax subsidy that is currently enjoyed by cafeteria plans. The tax subsidy for cafeteria plans gives rise to unequal tax treatment for workers whose employers choose to sponsor those plans and workers whose employers do not; and the subsidy is generally unavailable to nonworking people. Consequently, in the context of health care reform, elimination of tax-favored treatment of health benefits under cafeteria plans reduces inequities among employees and between employees and nonworkers.

In addition, the tax-favored treatment of health coverage provided through cafeteria plans promotes certain cost-shifting behavior by employers that, after health care reform, may be unnecessary or undesirable. Some cafeteria plans effectively shift the costs of health coverage from one employer to another. For example, when a employee's spouse works for another employer that provides health benefits, the first employer might offer a cafeteria plan in the hope of shifting the family's entire

coverage—with the associated employer cost—to the other firm. An employee who can obtain coverage under his wife's employer-sponsored plan, for example, might decline coverage from his own employer if that employer offers cash as an alternative. After health care reform, such attempts to shift costs between employers will be unnecessary. In general, under the Act all employers will pay a fair share of premium for all of their workers.

Currently, employers also use cafeteria plans for another type of cost-shifting. When firms reduce their health care costs by shifting them to their workers—requiring employee premium contributions or increased copayment and deductible cost-sharing—cafeteria plans are sometimes used to "sweeten the pill." Through the cafeteria plan, employees are permitted to pay the additional expenses on a pre-tax basis or to elect out of part or all of the health coverage.

The Act specifies the portion of the premium for the standard benefit package that is payable by employers and the portion payable by employees. Therefore, opportunities for employer cost-shifting to employees would generally be limited to situations in which the employer was voluntarily paying part or all of the employee share of the premium and wished to reduce that obligation. There would not appear to be a compelling case for making taxpayer dollars available to facilitate such cost-shifting.

B. Related Provisions of the Act

These limitations on the tax-favored treatment of employer-provided coverage are designed to work in concert with other provisions of the Act that provide incentives for cost-conscious behavior. For example, under the Act employers pay a specified percentage of the average premium for health plans in a region (subject to certain caps), while the employee generally must pay the balance of the premium—not for an average plan, but for the particular plan the employee selects. This means that the employee's obligation varies depending on the cost of the plan the employee chooses as compared to the average cost of plans in the region. This structure magnifies the financial impact on employees of their choice of plan, making them more sensitive to cost.

The Act also permits employers to pay more than their minimum required share of premium: employers may voluntarily pay for the entire cost of the plan, as many do today, or for less than' the entire cost but more than the Act requires. If a business chooses to pay for some or all of the worker's share of premium for coverage under the comprehensive benefit package, the employer-provided coverage will continue to be excludable from the worker's income and wages, as under current law.

In the interest of further enhancing employee price sensitivity, if a firm offers to pay part or all of the employee share of premium, an employee who chooses a plan that costs less than the contribution the firm offered will receive a cash rebate of the difference. Rebates will give employees another powerful incentive to weigh cost carefully in selecting a plan, because the employee receives in cash (which will be taxable) any amount that the firm voluntarily offers to pay but that the employee does not spend.

To help protect this incentive structure, the Act generally requires any employer that voluntarily pays the employee's share of premium to make an equal dollar contribution for all employees in the same region and enrollment category (with a prorata contribution for part-time employees). The voluntary employer premium payment may not vary depending on the plan the employee selects. It also may not exceed the employee share of premium in the employee's enrollment category for the most expensive plan in the region.

If employers were permitted instead to pay a specified percentage (100 percent or less) of the premium for the particular plan the employee selected (whether low-cost or high-cost), the employee always would use the entire employer contribution, could never receive a rebate for choosing a low-cost plan, and thus would be more insulated from the financial consequences of his or her choice. The requirement that any voluntary employer contributions be equal in amount regardless of which plan the employee selects helps to ensure that employees' out-of-pocket costs will depend on their choice of a costlier or less costly plan.

The equal voluntary contribution requirement under the Act also furthers the goals of tax equity and efficient use of the tax subsidy by preventing employers from making contributions that favor highly compensated employees or any other selected group. The simplicity of this equal contribution rule avoids the administrative difficulties that can be created by more complex anti-discrimination rules. The requirement that voluntary employer premium contributions extend equally to all employees does not apply to collectively bargained contributions.

C. Deduction for Health Insurance Costs of Self-Employed Individuals

Current Law

For taxable years beginning on or before December 31, 1993, section 162(l) of the Code permitted sole proprietors, partners, and more than two-percent shareholders of Subchapter S corporations to deduct 25 percent of the amount paid for insurance that constitutes medical care for the taxpayer and the taxpayer's spouse and dependents. The deduction was allowable only up to the amount of the taxpayer's earned income from self-employment and only if the taxpayer was not eligible to participate in any other subsidized health plan maintained by any other employer of the taxpayer or the taxpayer's spouse. This deduction is not available under current law for taxable years beginning after December 31, 1993.

Discussion of Provisions

The Act replaces the 25-percent deduction with a 100-percent deduction for self-employed individuals for the cost of providing coverage for the comprehensive benefit package that is purchased through a qualifying alliance. If the self-employed individual has employees and pays less than 100 percent of the weighted average premium for the comprehensive benefit package for those employees, the deduction for the self-employed individual's own coverage is reduced. In these circumstances, the permitted deduction for this coverage is reduced to the lowest percentage of the weighted-average premium that the self-employed individual pays for any of the employees (but in no event less than 80 percent).

The Act retains the limitation that the deduction cannot exceed the taxpayer's earned income. The current-law rule restricting the deduction to taxpayers who are not eligible to participate in a plan maintained by another employer is replaced by a rule denying the deduction to any self-employed individual who is also a full-time employee (i.e., at least 120 hours in a month) of another employer.

The increase to 100 percent will be effective for a taxpayer when the taxpayer is first eligible to purchase the comprehensive benefit package through a qualifying alliance or, if earlier, on January 1, 1997. Thus, the earlier a state establishes its alliances, the earlier self-employed taxpayers can claim the increased deduction. The prior 25-percent deduction for self-employed individuals is reinstated on the same terms as applied prior to its expiration, and remains in effect until the effective date of the 100-percent deduction.

The increase in deduction for self-employed individuals would conform their treatment to the treatment of other employers with employees. This would recognize that these taxpayers share many attributes with both employers and employees. For example, the reduction in deductibility to 80 percent for any self-employed individual who fails to make additional voluntary contributions on behalf of the individual's employees is consistent with an allocation of 80 percent of the cost to the employer and 20 percent of the cost to all employees.

V. TOBACCO EXCISE TAX INCREASES

The Act would partially finance health care reform by increasing federal excise tax rates on tobacco products. The tax rates on cigarettes and small cigars would increase by 75 cents per pack. The tax rates on large cigarettes, large cigars, cigarette papers, and cigarette tubes would increase by the same percentage as the tax rate on small cigarettes. Finally, the tax rates on snuff, chewing tobacco, pipe tobacco, and roll-your-own tobacco would increase by $12.50 per pound, the same per pound increase as the tax rate on small cigarettes.

Increasing the excise tax rates on tobacco products is an appropriate way of financing health care reform because of the significant health costs of tobacco consumption. Studies by the Department of Health and Human Services and the Office of Technology Assessment document the adverse health effects of tobacco consumption. Tobacco is the leading preventable cause of death and disease in the United States, each year accounting for more than 400,000 deaths and billions of dollars in health care costs. All tobacco products are addictive and contain carcinogenic substances. In fact, tobacco products cause cancer, emphysema, chronic bronchitis, and heart disease. Let me emphasize that the increase in tobacco excise taxes is more than a way to raise revenue. It is primarily a proposal to improve the health of Americans.

Raising tobacco excise taxes is widely considered to be the single most successful intervention to reduce tobacco use, especially among young people. The proposed excise tax rate increases on smokeless tobacco products in particular are likely to have a significant impact on consumption because of the high rate of smokeless tobacco consumption among young people. Studies have shown that nearly 20 percent of male high school students use smokeless tobacco.

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We would also note that the Act does not generally allow differential health insurance premiums for smokers and non-smokers. Thus non-smokers will bear some of the increased health costs of smokers.

APPENDIX B—COMMON LAW FACTORS USED TO DETERMINE EMPLOYEE STATUS

Workers are generally considered employees for Federal tax purposes if they:

1. Must comply with employer's instructions about the work.
2. Receive training from or at the direction of the employer.
3. Provide services that are integrated into the business.
4. Provide services that must be rendered personally.
5. Hire, supervise, and pay assistants for the employer.
6. Have a continuing working relationship with the employer.
7. Must follow set hours of work.
8. Work full-time for an employer.
9. Do their work on the employer's premises.
10. Must do their work in a sequence set by the employer.
11. Must submit regular reports to the employer.
12. Receive payments of regular amounts at set intervals.
13. Receive payments for business and/or travelling expenses.
14. Rely on the employer to furnish tools and materials.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from their services.
17. Work for one employer at a time.
18. Do not offer their services to the general public.
19. Can be fired by the employer.
20. May quit work at any time without incurring liability.

Source: Exhibit 4640–1, Internal Revenue Manual 4600 (Employment Tax Procedures), and Rev. Rul. 87–41, 1987–1 C.B. 296.

RESPONSES OF LESLIE B. SAMUELS TO QUESTIONS SUBMITTED BY SENATOR DOLE

Question No. 1. Are restaurants (the food service industry) covered under the Administration's Subchapter S payroll tax provisions?

Answer. The provisions you refer to are in section 7141 of the Health Security Act, which would treat the earnings allocable to an S corporation shareholder as net earnings from self employment, and therefore generally subject to self-employment tax under the Self Employment Contributions Act of 1954 (SECA), if (1) the shareholder owns more than two percent of the stock of the S corporation, (2) the shareholder materially participates in the S corporation's business, and (3) the income is derived from a service-related business. Your question goes to the last requirement.

Service-related businesses are defined by reference to the definition of those service-related businesses that do not qualify for the 50 percent capital gain exclusion in section 1202 of the Code, enacted in the Omnibus Budget Reconciliation Act of 1993. That provision (section 1202(e)(3)(A)) provides that service-related businesses include any business involving the performance of services in certain specified fields that do not relate to the food service industry, as well as "any trade or business where the principal asset . . . is the reputation or skill of 1 or more of its employees." That section further provides, in a subsection not cross-referenced for purposes of the Subchapter S proposal, that another type of business that does not qualify for the capital gains exclusion is "operating a restaurant, or similar business" (section 1202(e)(3)(E)). It appears from these provisions that restaurants generally should not be considered "service-related" businesses within the meaning of section 1202(e)(3)(A) and, correspondingly, the subchapter S proposal.

Question No. 2. Under the Health Security Act, service-related Subchapter S corporations defined as the "principle [sic] asset is the reputation or skill of one or more of its employees" would be subject to the employment tax provision. Would any kind of restaurant fall under this definition?

Answer. As explained above, the definition of "service-related" business for purposes of the subchapter S proposal is taken by cross-reference from one subsection of the capital gains exclusion provision (section 1202(e)(3)(A)). That section separately describes operation of a restaurant or similar business in a separate subsection (section 1202(e)(3)(E)) that is not incorporated for purposes of the Subchapter S proposal. Thus it appears that restaurants and similar businesses generally are not intended to be included under the general "service business" provision that serves as the basis for the Subchapter S proposal.

Question No. 3. Why are only "service-related" Subchapter S corporations covered under the payroll tax provision?

Answer. The proposal focuses on leveling the playing field among the various small business entities (sole proprietorships, general partnerships, limited partnerships, and subchapter S corporations), in order to reduce the potential for avoidance of health care obligations by conducting business through one type entity instead of another. Recognizing that many S corporations are more capital intensive than are sole proprietorships or partnerships (in which individuals materially participate in the business), we believe our proposal is the narrowest way to accomplish that objective.

Question No. 1. Are there any plans to expand the definition of "service related" business?

Answer. No. We believe this proposal appropriately balances the need to prevent abuse of the health care rules by leveling the playing field relative to partnerships without imposing difficult administrative and compliance burdens on small businesses.

PREPARED STATEMENT OF DAVE SCHERB

Mr. Chairman, members of the Committee . . . good morning. I'm Dave Scherb, Vice President of Compensation for PepsiCo. My background includes 20 years of "hands on" experience designing and managing corporate health benefits. I am also Chairman of the Washington Business Group on Health, although today I am exclusively representing PepsiCo.

Our practical knowledge about the impact of health care costs on economic growth and jobs is based on the shape and size of our enterprises. PepsiCo has been one of America's most aggressive growth companies. We have almost doubled our U.S. employment from I 82,000 to 332,000 in the past 5 years. A recent *Fortune* article predicted that PepsiCo may be the first company to reach a million employees, perhaps as early as the year 2000.

At PepsiCo, we successfully provide quality health benefit plans, with cost increases well below the national average. This has been accomplished through a lot of hard work, competitive purchasing and innovation. However, I'd be the first to recognize that there are limits to what we'll be able to achieve without health system reform. For example, our business partners at Pepsi-Cola and our restaurant divisions include thousands of independent franchisees who don't necessarily enjoy the efficiencies and market clout of the biggest corporations. We also have first hand experience with health care access issues for both manufacturing and service jobs. We operate the gamut from large Frito-Lay manufacturing plants down to small Pizza Hut delivery stores.

THE NEED FOR HEALTH CARE REFORM

We clearly have a big stake in solving the difficult health care issues facing American businesses and workers. PepsiCo wants to see health care reform enacted this year, and we applaud the President's leadership, as well as the leadership of Senators and Congressmen from both parties, in bringing this issue to the fore.

Based on our review of the Administration plan, as well as some of the legislative alternatives that have been presented, we're very concerned about serious unintended consequences. Our concerns center on too much government involvement in general, but in particular on the detrimental impact employer mandates would have on PepsiCo's business, our employees and the economy at large.

We strongly believe that market based reforms can control cost and achieve universal coverage without mandates, and in this testimony I will tell you why. Moreover, we are optimistic about reform this year because of the increasing number of alternative plans that seem to be coming to a similar conclusion. *The formula for success is to phase in reforms that Americans can support, in a logical sequence that does not create unnecessary economic dislocation for workers.*

The *first* step is to enact those near consensus reforms that will provide security and portability for the 85% of Americans who already have coverage, and enhance competition to control cost.

Second, for the 15% who don't have coverage, remove the barriers to access by (a) requiring all employers to offer plans, and (b) providing means tested subsidies directly to disadvantaged individuals. With barriers to access removed, many of the uninsured population *will* enroll, and coverage will rise well above 90%.

This brings us to the core of the issue of health reform and universal coverage, as many of us in the business community with the practical experience of providing coverage to our employees see it: How do we reach the small percentage that will slip through the net and remain uncovered after the initial reforms are in place?

I will explain our idea for solving this problem later in the testimony, after considering the framework which lead us to these conclusions.

WHY EMPLOYER MANDATES ARE THE WRONG ANSWER

Before going any further, I will give you our perspective on employer mandates. My message about mandates can be summarized quite simply: *Beware the Unintended Cost of Good Intentions.* On the surface, the employer mandate may sound good . . . but, in reality, it is a very dangerous concept for two basic reasons.

1. Companies don't pay the cost of mandates. Workers pay through lost jobs and reduced wages. In fact, because mandates are regressive, they will hurt the very people they are intended to help.
2. Employer mandates are unfair and inefficient. They will create huge economic distortions, as billions of dollars change hands among companies and individuals that already have insurance. In other words, mandates put government in the position of choosing winners and losers in the general economy and job marketplace.

In a Gallup Poll two weeks ago, 63% preferred a plan that gives them the right to buy affordable insurance but does not require them to buy it. This should be a red flag. Consider the public outcry a few years back that led to the repeal of Catastrophic Medicare.

Some might simply write this off as a reaction to individual mandates, but I disagree. As someone who has had to pass on health care rate increases to employees, I'm convinced that the negative reaction will be even greater once workers understand that they will have to bear the cost of employer mandates as well.

Will employees get the bill for employer mandates? You bet they will. Ask the vast majority of economists or human resource experts. Ask any small business owner or corporate CEO who is facing a significant cost increase. Most will tell you that over 80% of the cost for employer mandates will be passed on to employees in lost jobs and lower wages. It won't be hidden, and it won't be subtle.

A recent study by Consad Research estimated that, under the Administration's mandate, 23 million workers would get less pay and fewer benefits, and some 850,000 would lose their jobs. Without subsidies to employers, which will cost taxpayers more than $80 billion, the job losses would approach 3 million.

Why would employees feel the impact of employer mandates *starting almost on day one?* Once the direction was reasonably certain, perhaps while Congress is still negotiating the details, companies would reassess their one-year and five-year plans to account for the higher estimated costs. The first place they'd look for savings is jobs and wages. Why? Because labor is the most immediately controllable cost, and it is the cost that would be going up under the mandates. Business would certainly not chase away capital investment and shareholders by lowering the profit targets. Nor would business be inclined to chase away potential customers by increasing prices. If demand was inelastic, prices would have gone up already to increase profits. Since domestic inflation and wages have only been going up about 3% per year, there isn't much room for passing on price increases. Three percent also doesn't leave much room for passing costs on to employees in their paychecks. Unfortunately for many, the result wouldn't just come in reduced wages, it would also mean lost jobs.

REDUCED EMPLOYMENT OPPORTUNITIES AT PEPSICO

Let me be specific, using PepsiCo as an example. We employ people in three industries. Soft drinks and snack foods are the first two, and they are basically traditional manufacturing industries. Employees are full-time, they turnover infrequently, and they receive relatively high wages and benefits.

We also run major restaurant chains, including Pizza Hut, Taco Bell and KFC. This industry segment is characterized by large numbers of part-time employees. Turnover is high, wages are low and benefits are limited. This is where the Administration's proposal would have the greatest impact.

The mandate would increase our restaurant labor cost by over 20%, which equates to about 6% of total sales. If we took no action, which of course would not be the case, this would reduce our restaurant divisions' profits by two-thirds. Our earnings are well above the industry average. For most other companies in the restaurant industry the mandate would wipe out profits altogether.

Now 6% may not sound like much, but let me put it in perspective using Pizza Hut as an example At current prices, to replace 6% at the bottom line Pizza Hut would have to increase top line sales by $850 million per year. That would require a 33% increase in sales over 1993: *the equivalent of 121 million pizzas.*

Some would say, fine, but why can't you simply increase your prices 6%. After all it's a level playing field and your competitors will have increased cost as well. Unfortunately it's not a level playing field, and our biggest competitor is home cooking. The same constituents that tell you they don't want to pay more taxes tell us they don't want to pay more for pizza. They vote by not coming to our restaurants as often. Economists set the price elasticity in our business at about 2.5 to 1. That means a 6% price increase results in a 15% sales drop, beginning a downward spiral of lower profits requiring further price increases, etc.

So how would we respond without raising prices? We'd be forced to reduce our reliance on labor intensive activities. We'd automate. We'd prepare food in central commissaries instead of at the store location. We'd shift the future growth of our business to less labor intensive points of distribution, such as convenience stores and supermarkets. The result would be a reduction of jobs in the tens of thousands.

In spite of these efforts, some restaurants would become unprofitable and would be closed. Also, the hurdle for opening new restaurants would become higher, making capital investment in less labor intensive enterprises relatively more attractive. But that would not be our preference.

For the past five years, we've been building restaurants at the rate of one a day. This year we'll build two a day. That's right, on average a new PepsiCo restaurant is opening every twelve hours all year long. Each is a $1 million business that adds to the tax base and employment in local communities across America. That means job opportunities in real estate, building and construction, goods and services and other sectors of the economy. So you see, the damaging impact of employer mandates would go well beyond the food service jobs we provide directly.

A NEGATIVE IMPACT ON BUSINESS OVERALL

This is not just a problem. for small business and a few large companies like PepsiCo that employ part-time workers. According to Lewin VHI, *80% of all U.S. companies would face a cost increase under the Administration's mandate proposal.*

Among companies that don't currently provide coverage, the Administration's plan would cost $29 billion annually. But among companies that do provide coverage, there would be new costs as well. Almost half would incur an increase of $100 per capita for a total cost of $46 billion annually. Add the numbers up, and we're left with 80% of all employers collectively facing a *$75 billion problem.*

Of course there are also companies who save. About half that provide insurance now would save $46 billion a year. But I don't think the winners are likely to help the losers. Most of the companies that would save are in the high wage manufacturing sector, while most of the companies that would suffer increased costs are in the lower wage service sector.

SERVICE SECTOR HIT . . . JOB GROWTH ENDANGERED BY EMPLOYER MANDATE

There's another myth that job and wage loss would only hit small employers, and that big company workforces would be largely unaffected. Let's look at the facts.

Over the past ten years, employment among the Fortune 500 industrials decreased by 3.4 million jobs. However, between 1982 and 1992, employment grew by 11.8 million jobs among the Fortune 500 service companies. The Service 500 includes companies like Walmart, Bank of America, J.C. Penney, UPS, Marriott and American Express.

PepsiCo is not in the Service 500, even though over two-thirds of our jobs are service-related. PepsiCo is the second largest employer in the Industrial 500. If you look through the industrials, you'll find that many manufacturing companies have moved into service businesses as well . . . and many employ part-time workers.

According to the Consad study: *45% of lost jobs under the Administration plan would come from companies employing more than 500 workers, and 64% would come from the service and retail industries.*

EMPLOYER MANDATES ARE UNFAIR AND REGRESSIVE

There seems to be an inherent assumption among proponents of mandates that it is fair and in society's best interest to transfer a large percentage of health care costs from older, more highly paid workers in mature, manufacturing companies, to lower paid and younger workers in growing industries such as services. We think that assumption is wrong.

Those favoring mandates also seem to be saying that it is competitively unfair that some employers pay for coverage while others do not, and all should pay an equal share so there is a level playing field. My response is that there is nothing fair about a mandate, and it certainly does *not* create a level playing field. Business

conditions dictate the playing field, and mandates hit hardest on companies in poor financial condition.

If we accept the near consensus among economists that employers pass most of the cost of benefits on to their workers through lost jobs and reduced wages, then employers who have allocated a portion of total compensation to provide health coverage are certainly not at an unfair competitive disadvantage. In fact, as long as their workers value health coverage, the tax system has given these employers a distinct advantage. Since health benefits are excluded from taxable income, compensation dollars spent on health plans go one-third further, and taxpayers pick up the tab.

Historically, the greatest health subsidy in this country has gone to those with the highest wages and the richest benefits. Now, in the guise of "fairness," mandates would shift cost to those with the lowest wages.

What is fair about community rating that shifts cost from 55-year-old workers to 25-year-olds? People in their 50's are the most highly insured age group below Medicare age. They have the lowest unemployment rates. Their homes are paid for, kids through college, and they have had years to save. Teenagers, and those in their 20's, are the most highly uninsured age group and most highly unemployed. They don't have savings and are struggling for a down payment on a home, or, for that matter, a home appliance. Ironically, those who will feel the greatest burden from mandates will be the very people the mandates are supposed to help: the uninsured.

A recent analysis by the Center for the Study of Business and Government concluded that *uninsured workers would suffer wage cuts averaging $873,* as employers passed on the cost of mandates. This is a tough pill to swallow since *the average uninsured worker earned only $14,962 in 1993!*

Unfortunately, taxes and mandates are often paid by persons other than those assessed. Lewin VHI estimates that *53% of Americans would realize a net decrease of income* (including wage reduction and health costs) *under the Administration's plan. For 31%, it would amount to $1,000 or more per year.*

I would suggest that much of this cost shift is among those who already have insurance, and not the price of expanding access to those who do not.

Under the Administration mandate proposal, after creating all the winners and losers, what will we have gained?

- Security? Most non-mandate proposals already provide that, and access for the uninsured as well.
- Lower cost? The Administration predicts its plan will cut cost in 1999 from 19% to 18% of GDP, but that still leaves us 40% above Germany and Japan!

THERE IS A BETTER WAY . . . WITHOUT MANDATES

As I mentioned earlier, we applaud the President's initiative and agree with his ultimate goal of universal coverage. Dropping employer mandates does not mean we give up that goal. It simply means we recognize employer mandates are not the way to achieve it.

Knowing what we know about employer mandates and their unintended consequences, we challenge the concept that health reform should focus on radically overhauling a system that provides the best health care in the world to 85 percent of the population, by disrupting that same 85 percent and threatening the very job security which allows them to be insured.

Further, with the enactment of certain reforms which currently enjoy a near consensus within the Congress and Administration, and support among the American people, most experts agree that we could reasonably bring the number of insured in this country to 92-94 percent.

Considering the problem from this framework convinces us that our efforts should be concentrated on how to deal with the remaining segment of the population that cannot be reached by consensus reform. With this in mind, it is our position that efforts to provide health reform and achieve the goal of universal coverage should be targeted and designed to capture the 6-8 percent of the population that represents the truly uninsured segment of the American public.

Phase I: Enact those near consensus reforms that will provide security and portability for 85% of Americans who have coverage, and enhance competition to control cost.

Health care cost control and security, or coverage that no one can take away, are on the top of the list of what Americans want. They are also the underlying enemies of access. Today, almost all proposals advocate increased competition to drive inefficiency out of the system. When it is working, the market based system is Darwinian in its ability to control cost.

However, it is not working. What needs fixing the most is the market for small employers and individuals. By combining their purchasing power in cooperatives they will for the first time be able to realize the purchasing leverage and administrative economics of scale that companies like PepsiCo now enjoy. This would have a tremendous impact on administrative costs alone, for both insurers and employers, as enrollment and other procedures are standardized, and coverage becomes portable between jobs.

Other actions to reduce cost for all purchasers, large and small, should focus on the delivery system. These should include malpractice reform and administrative simplicity. Everyone wants to eliminate paperwork on claims, and to add health care to the electronic information highway. We also need to give consumers better information so they can become wise purchasers, and require outcome and service data from providers to assure quality doesn't suffer in a more competitive environment.

Lower cost automatically means greater security as coverage remains more affordable. But security also means new insurance rules to ensure that no one can be denied coverage due to pre-existing conditions, or have their coverage cancelled or their premiums increased due to individual health problems.

These, and other reforms that are common features of most proposals should be enacted quickly, and not held hostage because of disagreements over other elements of reform.

Phase II: For the 15% of Americans who don't have coverage, remove the barriers to access by requiring all employers to offer plans, and by providing means tested subsidies directly to disadvantaged individuals.

Making coverage more affordable and requiring all employers to offer plans will reduce the uninsured substantially. Four million small employers do not have group insurance plans, forcing many workers, as well as self-insured, to buy individual policies at 1 .5x to 2x the cost. Many employers would contribute voluntarily to a plan if it were available at stable group rates.

Individual subsidies for those earning up to 200% of the federal poverty level will help 60% of the uninsured afford coverage. Full subsidies up to Ix the federal poverty level will provide coverage for 28%, and a sliding scale up to 2x will help another 32%. Paying direct subsidies to individuals is much more efficient than employer subsidies combined with a mandate. Not only can we be sure money goes to the low income individuals who need it, but the government does not waste precious dollars underwriting the health care costs of prosperous businesses and removing their incentives to control cost. The funding for subsidies should first come from existing health system expenditures, and support cost control goals. Adding new funding streams, like payroll taxes, will only make it more difficult to get health inflation under control. At least three funding options in many current reform proposals meet these criteria.

1. *Reduced Medicare/Medicaid Expenditures:* The reductions should not be draconian, certainly not more than the historical five year high of previous reductions. Also, once reforms begin controlling costs, the goal should be to end further cuts and stop the public to private cost shift.

2. *A cap on Employer Tax Deductions and Individual Exclusions:* By using a dollar cap that is based on the average local community cost for a "standard plan," significant revenue would be raised. Equally important, employers, workers and providers would all have a powerful incentive to control cost. Not only would overly rich plans be discouraged, but cost efficient providers would be rewarded with more business.

This approach is far superior to the mandate because it is progressive. Based on CBO studies, about 65% of the revenue would-come from those earning $50,000 or more. Also, we can determine precisely who is impacted by adjusting the tax cap based on income levels (e.g., no cap under $30,000, etc.).

3. *Disproportionate Share Payments:* As subsidies increase coverage levels among disadvantaged populations, uncompensated care will decrease, and free up this significant revenue source. These payments could be eliminated altogether if an Uncompensated Care Plan were implemented (see next section).

In Phase I and II, we will have directly addressed the primary concerns of our fellow citizens. We will have provided security for the 85% of the population that has coverage already, since it will be more affordable and no one will be able to take it away. We will have expanded access for the 15% that don't have coverage, since they must be offered a plan to buy and will be given subsidies if they can't afford it. And we will have done this *without a government takeover of health care and without mandates.*

These actions would significantly reduce the number of uninsured. Some say 15% of uninsured Americans would be cut by more than half, perhaps bringing the number of insured up to around 94%. *But how do we make sure that we achieve that level voluntarily, and how do we close the remaining gap?*

Phase III: Capture the remaining small percentage of uninsured by automatically enrolling them in insurance to achieve universal coverage

This brings us to the core of the issue of universal coverage. How do we identify and reach the 6–8% who, after all our efforts to reduce cost and provide access, still don't sign up for plans? It seems to us they would be primarily composed of two groups.

First, are those who didn't access the system because they did not understand how to because of education, language barriers, etc. They may even be low-income individuals eligible for subsidies they didn't know they were eligible for.

Second, are the so-called "free riders." They have the money but choose not to cover themselves. They may be irresponsible or even living outside the system, such as those who don't file taxes.

Our solution would be to provide a safety-net that captures the uninsured by automatically enrolling them in an Uncompensated Care Plan, and by making sure they pay for the coverage if they have the means.

The mission of the Uncompensated Care Plan would be to identify uninsured individuals, provide *temporary* coverage, and through a combination of help and financial incentives get them enrolled as quickly as possible in private sector insurance. This would achieve:

- Universal Coverage.
- An end to uncompensated care.
- And, a mechanism to assure that everyone who uses the health care system pays, if they have the means.

Here's how it would work. The Plan would guarantee reimbursement to health care providers whenever they treat an uninsured patient. The provider would submit a claim to the Plan. When the claim is processed, the individual would automatically be enrolled.

The Plan would then contact the individual with two goals: to determine if they need help finding a local private plan to enroll in . . . and to obtain payment for the temporary coverage provided by the Uncompensated Care Plan at the same benefit levels as private insurance.

"Free riders" would be charged a premium for coverage plus a substantial penalty as an incentive to buy private insurance on their own. The penalty would be means tested based on income . . . and, for repeat "free riders," a higher scale could be used. Disadvantaged individuals would be steered toward subsidies and receive assistance signing up for private insurance.

The Plan would be administered at the state level, possibly under the control of the Insurance Commissioner, and could involve local Human Services Agencies to help individuals enroll in private plans. Enforcement of uncollectibles could be aided by the IRS or through a streamlined collection process.

The Uncompensated Care Plan should be close to self-funding. Adverse selection will be minimized since reform of the private market will have prohibited denial of coverage to those with health problems. Above market premiums, penalties, and unused government subsidies will provide the bulk of funding. Even with the best efforts collection from some individuals will not be successful. However, supplemental funding could come from disproportionate share payments no longer necessary now that uncompensated care is eliminated.

In addition to ensuring universal coverage, we believe this approach would:

- Focus enforcement of access on the relatively small population that doesn't voluntarily insure themselves.
- Get providers out of the collection business, and the cost shifting business.
- Show the American people that we've taken care of the uninsured, and the "free riders."
- Avoid government underwriting of the cost of business.
- Efficiently target subsidies to individuals on a means tested basis.

This is certainly not the only mechanism, and I'm sure it can be improved upon. We deliberately call our concept a mechanism, rather than an alternative reform proposal, because we believe it could be attached to any number of alternatives now under consideration. In fact, if the long term goal is to build on the private system rather than add to the rolls of government entitlement programs, it would seem a back-end enforcement mechanism is a must. The main point is: *We don't have to*

turn the health system upside down and cause reduced wages and lost jobs under mandates to achieve the goal of universal coverage.

Mr. Chairman and Members of the Committee, thank you very much for the opportunity to testify today.

COMMUNICATIONS

STATEMENT OF THE AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

INTRODUCTION

The Section of Taxation ("Tax Section") of the American Bar Association ("ABA") respectfully submits the following comments on the classification of workers as employees or independent contractors under health care reform, particularly S. 1775, the Administration's health reform proposal. The comments are submitted solely on behalf of the Tax Section. They have not been approved by the House of Delegates or the Board of Governors of the ABA and should not be construed as representing the position of the ABA unless clearly stated.

The ABA, through the Tax Section and its committees, has considered the worker classification issue in the income and employment tax context over the years. For example, in 1982 the ABA adopted a legislative recommendation proposed by the Tax Section that a safe harbor definition of employee be adopted for employment tax purposes, and that the penalty for failure to file an information return for payments to an independent contractor be increased. In 1992 and 1993, respectively, representatives of the Tax Section testified before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee and the House Committee on Government Operations in support of the development of a more administrable definition of employee than under current law, as well as codification of section 530 of the Revenue Act of 1978 and its extension to the income tax area. Most recently, on February 8, 1994, a representative of the Tax Section testified before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on the classification of workers as employees or independent contractors and self-employment tax changes under the Administration's health reform proposal.

A. Overview

Under S. 1775, the amount paid by or on behalf of a worker for health insurance would depend on the worker's status as an employee or independent contractor. Although other definitions exist that employers must apply, S. 1775 would rely on the definition of an employee that is used for purposes of the employment tax provisions of the Internal Revenue Code ("Code"). The Administration's section-by-section analysis of S. 1775 explains that this was done to "minimize the administrative and compliance burden on firms," presumably because most firms are more familiar with the employment tax standard than any other.

Currently, a 20-factor test based on the common law is used to determine whether a worker is an employee for employment tax purposes. The factors are subjective, overlapping, and in some cases irrelevant to the particular work situation. The 20 factors are set forth solely in Internal Revenue Service ("IRS") guidance, not in regulations. There is no guidance at all for determining how the factors should be weighed or how many factors must be met before a worker will be classified as an employee or an independent contractor. In addition, since Congress enacted Section 530 of the Revenue Act of 1978 ("Section 530"), both the Treasury Department and the IRS generally have been prohibited from issuing any general guidance on this issue.

S. 1775 would change this situation in several significant respects. First, it would direct the Treasury Department to issue regulations setting forth rules for determining a worker's status as an employee or independent contractor. S. 1775 would require the regulations to give "significant weight to the common law," but otherwise would provide little guidance to the Treasury Department. Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels testified before the Finance Committee on May 3 that "these prospective changes will not cause substantial reclassification of workers in the future from their current status under the employment tax

rules." However, the law would not prevent significant changes in status for workers at the margin. S. 1775 also would limit the protection provided to employers by Section 530, which generally prohibits the IRS from reclassifying a worker as an employee if the service-recipient has a reasonable basis for treating the worker as an independent contractor. Finally, S. 1775 would increase significantly the penalty for failing to report on Form 1099 payments made to an independent contractor.

B. Comments

The Tax Section is concerned about several aspects of the pending legislation, including (1) the changes that S. 1775 would authorize in the definition of employee for tax purposes; (2) the kind of regulations that the Treasury Department would be likely to issue in this context; and (3) the process by which those regulations would be developed.

1. DEFINITION OF EMPLOYEE

The Administration has expressed the view that some changes in current law are needed to prevent abuse of the employer mandate and the special premium discount for low-wage small employers in the bill by deliberate misclassification of employees as independent contractors, and that the Treasury Department should be authorized to effect those changes by issuing regulations clarifying the definition of employee. However, the long history of the classification issue indicates that it is highly dependent on the facts and circumstances of particular cases, and cannot be dealt easily with in guidance of general applicability. Assistant Secretary Samuels himself notes that "it is difficult to have a specific one size fits all" statutory definition applicable to the many varied existing worker relationships."

In fact, we believe that the simplest and most reliable way of addressing the misclassification problem is by eliminating unnecessary "tax" differences in tax treatment between employees and independent contractors. Such differences encourage misclassification and cause it to have adverse revenue and other consequences to the government.

Recognizing this situation, reform efforts in the FICA and income tax withholding areas have focused on eliminating differences in the total tax burden on employees and their employers, on the one hand, and independent contractors and their clients, on the other. Before 1983, the total tax burden on independent contractors and their clients was much less. In 1982 testimony, the Treasury Department recommended that this differential be reduced "to help neutralize the decision whether to hire an independent contractor or an employee, and relieve pressure on the question of employment status." Reacting to such recommendations, legislation in 1983 mostly eliminated the rate differential and made other conforming changes that became fully effective in 1990. During the same period, efforts have been made to improve the enforcement of independent contractor obligations, which historically have not been enforced as effectively as employee obligations are enforced through withholding. As a result, misclassification has become essentially revenue-neutral. Moreover, in our experience, these developments have made misclassification less of a compliance problem in the employment tax area.

By contrast, S. 1775 would exacerbate the misclassification problem by increasing significantly the financial incentive for workers to be classified as independent contractors. This incentive would result (1) primarily from the fact that workers classified as independent contractors would be much more likely to qualify for special small-employer discounts in their health insurance premiums than workers classified as employees, and also (2) from the fact that the general 7.9 percent of payroll limit that the bill would impose on health insurance premiums would apply on an aggregate, firm-wide basis to workers classified as employees, while it would apply on a worker-by-worker basis to workers classified as independent contractors, making it much more likely to apply to independent contractors.

As long as this incentive exists, we believe that it is inevitable that government enforcement efforts—including Treasury regulations—will be biased in favor of employee status. The resulting tug-of-war between taxpayers and the government is unlikely to simplify the task of classifying workers based on the economic substance of their work relationship. Rather, it will encourage considerable creativity by taxpayers and correspondingly elaborate counter-measures by the government. Over the long term, the existence of this financial advantage to independent contractor status will result in the greater use of true independent contractors, a trend that is beyond the reach of mere tax regulations. In tax policy as in medicine, the guiding principle should be "first, do no harm."

The bias created by the premium discounts and payroll-based limits on health insurance costs in S. 1775 in favor of independent contractor status could be eliminated by (1) converting the small-employer discount to a general low-income dis-

count that would be available with respect to coverage provided to *any* low-income worker, and (2) applying that discount and any other limits on health insurance costs on a worker-by-worker rather than on an aggregate, firm-wide basis.

Similar approaches to those noted in the previous paragraph are taken in other health reform bills. Both approaches noted in the previous paragraph are characteristic of health reform proposals built around an individual, rather than an employer, mandate. A general low-income subsidy is part of the bill reported out of the Subcommittee on Health of the House Committee on Ways and Means. A worker-by-worker limit on the cost of health insurance has been suggested by Sen. Mitchell, and is part of the Chairman's mark under discussion by the Senate Committee on Labor and Human Resources.

Of course, as Assistant Secretary Samuels pointed out in his testimony, the classification issue will continue to arise in any health reform legislation that involves any kind of employer mandate. "Employer mandate" in its traditional sense refers to a requirement like that contained in S. 1775 that an employer contribute to the cost of its employees' health insurance. "Employer mandate" in a broader sense also includes any obligation based on a taxpayer's status as an employer, including a requirement that the taxpayer make health insurance coverage available to its employees, a requirement that the taxpayer withhold employees' premium payments from their wages, and a maintenance-of-effort ("MOE") provision requiring taxpayers now providing health insurance to their employees to continue to do so for some period of time.[1]

However, the various employer mandate requirements noted in the previous paragraph do not create the same incentives for misclassification as the small employer subsidy and payroll-based limits on health insurance costs in S. 1775. Economic theory holds that the cost of an employer contribution requirement is, like the FICA tax, passed on to workers in the form of reduced wages, and thus does not change the overall cost of hiring an employee compared to an independent contractor.[2] The other requirements included in the broad sense of "employer mandate" generally are less costly than an employer contribution requirement. Some of them—such as a requirement that health insurance be made available to all workers, or a withholding requirement—might under appropriate circumstances be able to be extended to independent contractors as well as to employees. Finally, a MOE provision generally is temporary, and can be limited to individuals who were benefiting or eligible to benefit under the employer's plan on a particular date, thus avoiding any classification issue.

Regardless of how the above issues are resolved, if the classification of workers as employees or independent contractors is addressed in the context of health reform, the Tax Section believes that Congress should (1) take up the Administration's invitation and explain in the legislative history of the legislation, as explicitly as possible, what types of reforms it would consider appropriate, and (2) direct the Treasury Department to provide balanced rules that do not favor consistent characterization as an employee, that are as simple as possible, and that assure adequate transition relief. The Tax Section is concerned that, as a practical matter the Treasury Department might not be as sensitive as Congress to the importance of providing simple, clear rules on which employers can rely, or of minimizing changes in business practices and providing sufficient transition time to implement any changes that are necessary.

For example, S. 1775 provides that regulations issued by the Treasury Department will be effective six months after they are issued in final form. This delay is

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[1] In his testimony on May 3, Assistant Secretary Samuels suggested that a MOE requirement would be necessary if an individual mandate were adopted. This assumes that employers currently providing benefits would drop them if an individual mandate were adopted, and that a MOE requirement would be needed to limit the disruption of workers now receiving employer-paid health insurance, and to prevent a windfall for employers that have already funded the insurance by reducing employees' wages. It is not inevitable that employers who now provide health insurance to their employees will react in this manner to an individual mandate.

In this connection, we believe that Congress should carefully consider the disadvantages of a MOE requirement. For example, a MOE would perpetuate—albeit presumably for a limited period of time—the unlevel playing field between employers that provide health insurance to their employees and those that do not. Experience with the MOE requirements in the Medicare Catastrophic Coverage Act of 1988 and section 420 of the Code also indicates that they are difficult to administer and, depending on their design, can create perverse incentives to maintain rather than reduce health care expenditures. We are studying these issues, and would be pleased to discuss them with the Committee in more detail if the Committee wishes.

[2] *E.g.*, Steuerle, *Individual Mandates and Tax Reform*, 61 Tax Notes 1115 (Nov. 29, 1993) ("There is almost no argument other than political for an employer mandate over an individual mandate. . . . [A]lmost all economists believe that employer mandates are paid by workers mainly in the form of lower wages . . . .").

far too short to implement the far-reaching changes such regulations would require. At a minimum, the period should be extended, and should end only at the end of a year, to reduce disruptions to employers' payroll systems and their respective accounting tax years.

The importance of these goals is increased to the extent that any new definition of employee that is developed for health care purposes applies for income tax and other purposes as well as for employment tax purposes. For example, under S. 1775 the Treasury Department's decisions would determine the status of workers for purposes of the qualified plan provisions of the Code. In the qualified plan area, clear rules are essential to ensure that employees receive the benefits to which they are entitled and are provided the protection of ERISA. Similarly, sudden changes in the status of workers as employees or independent contractors would put such plans at risk of violating various tax qualification requirements, since those requirements generally look solely at the number of *employees* in a business and the benefits that *they* receive.

A number of different approaches have been suggested to the problem of classifying workers as employees or independent contractors that Congress might consider in providing guidance to the Treasury Department:

- Some observers advocate replacing the 20-factor test with other, more objective standards. Standards that have been suggested include whether the service-provider has his or her own employees, maintains his or her own office, works for more than one service-recipient during the year, or has a written contract with the service-recipient. This approach is often suggested as a safe harbor that would apply in addition to rather than in lieu of the 20-factor test. As noted above, the ABA adopted a legislative recommendation in 1982 that contained such a safe harbor.
- Other observers have advocated improving the 20-factor test either by eliminating any overlapping factors and distilling the remaining factors down to a shorter list, or by ranking the existing list and/or organizing it into a set of alternative or cumulative requirements. The IRS took this approach in its recently-issued market segment program ("MSP") guidelines for the classification of certain workers in the entertainment industry.
- Other observers have suggested allowing a worker or service-recipient to elect whether to treat the worker as an employee or independent contractor, as long as the service-recipient files whatever information returns are appropriate for the worker's status. It is doubtful whether this approach would be feasible under S. 1775, however, as long as the small-employer premium discount creates a significant incentive to re-classify workers as independent contractors even if the worker is fully compliant with all applicable requirements.

The Treasury Department has suggested taking an industry-by-industry approach to the classification issue like that taken in the IRS's Compliance 2000 program (including the MSP). We believe that such an approach would be helpful, but probably would not provide a complete solution. Over the years, the IRS has found it difficult and time-consuming to reach agreements with different industries. Few industries have agreed to participate. MSP guidelines for certain workers in the entertainment industry were released recently. However, they took over a year to develop, and are complicated in their own right. The experience suggests that it would take considerable time to draft regulations using an industry-by-industry approach.[3] It would be difficult for Congress to speed the process by requiring the IRS and industry representatives to confer on a cooperative basis to develop a definition of employee that is appropriate for that industry. In addition, we are concerned that the IRS would enjoy considerably more bargaining power than under current law if the Treasury Department were given the authority to issue regulations if an agreement could not be reached.

2. SECTION 530

S. 1775 makes a number of specific changes to Section 530. As noted above, the Tax Section supports some of those changes. However, we are concerned by several aspects of the proposal. For example, we do not believe that the IRS should be able to terminate an employer's reliance on Section 530 unilaterally, simply by notifying the employer of that fact, until it has issued general guidance that better defines an employee. We are particularly concerned that such action apparently would be permitted without an audit or any other contact.

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[3] In particular, Assistant Secretary Samuel's estimate in his remarks before the Finance Committee on May 3 that it would take two years to write regulations in this area seems optimistic.

3. PENALTIES

S. 1775 would increase the penalty for failing to report some or all of a payment made to an independent contractor on Form 1099 to the greater of $50 or five percent of the amount involved. Since a worker who knows that a payment has been reported to the IRS is more likely to include the payment in income when he or she files his or her income tax return and pays the tax, the Tax Section has previously endorsed the concept of enhanced information reporting penalties. The ABA's 1982 legislative recommendation urged Congress to increase the penalty authorized by the Code for a failure to file an information return with respect to payments to an independent contractor from $10 (the rate applicable in 1982) to $50 for the first failure. The legislative recommendation also urged Congress to enact an enhanced penalty for a failure to file information returns occurring after the initial assessment of the information return reporting penalty.

The enhanced penalty apparently would apply only to information returns required to be filed with the Service and not to a failure to furnish correct payee statements under section 6722 of the Code. Since notifying the payee that amounts have been reported to the IRS is a very important stimulus to proper reporting by the payee, we believe that the section 6722 penalty should be considered carefully in the context of any new penalty structure in this area.

In the past, the Tax Section has supported proposals to increase the penalty for failure to file a required information return with respect to an independent contractor in the context of other proposals that would reduce the risk of large retroactive tax assessments when workers are reclassified as employees. Thus, in connection with the changes made by S. 1775, Congress should consider reducing the amount assessable under section 3509 of the Code for misclassification of workers at the same time, unless the misclassification is attributable to intentional disregard for rules or regulations. In the alternative, Congress should permit taxpayers that have misclassified their workers (but without intentional disregard of rules or regulations) to agree with the IRS to reclassify workers as employees prospectively, rather than litigate the classification issue for prior periods.

4. ADMINISTRATIVE ISSUES

Administrative simplicity is an important goal of any health reform proposal. Although the Tax Section is sympathetic to, and generally supports, the Administration's decision in S. 1775 to apply the same definition of an employee (including the special rules of Section 530) for employment, income and health insurance purposes, it is important to remember that uniformity is only one element of the simplicity and administrability of a definition. Uniformity would not be worth the price if it came at the cost of an excessively complicated or biased definition of employee. Thus, we are concerned by the bewildering number of government agencies that would have a role in determining whether a worker is an employee. Under S. 1775, the Department of Labor, state governments, and regional alliances all would have roles in enforcing the employer mandate and in determining whether the small-employer premium discount is available, while the IRS would continue to enforce the income and employment tax provisions of the Code. Unless their enforcement efforts are closely coordinated, and one agency—presumably the IRS—is given final authority to determine how the definition of employee applies in a particular situation, multiple and often conflicting interpretations of the definition inevitably will develop, *increasing* rather than decreasing an employer's administrative burden, and reducing the ability of even the most compliant taxpayers to rely on determinations made by a single agency.

We have similar concerns about the administrative complexity of the premium-collection process proposed under S. 1775. The bill provides little detail on this issue and, unlike the Code, does not even delegate authority to one agency to develop rules. To minimize the administrative burden on the government and those who are required to contribute, any collection procedures should be integrated to the extent possible with whatever existing collection procedures they most closely resemble. Since S. 1775 requires premiums to be collected relatively frequently, this might be the federal tax deposit system. In this regard, we hope that political concerns over what is or is not characterized as a tax for budget purposes will not prevent the adoption of the best rules.

It is also important that the premium-payment requirements in S. 1775 be adequately enforced. First, increases in the size of the economic burden for employment taxes and mandatory health insurance premiums might well increase the number of employers and employees who seek to escape the tax and health system entirely by simply not reporting their relationship. This problem may be even more acute in the health care context than the employment tax context, since, unlike the social

security system, individuals with no work history would still be entitled to benefits, and, if universal coverage is guaranteed, it would be difficult or impossible to deny treatment for nonpayment of premiums. Second, failure adequately to enforce the requirement that independent contractors pay premiums on the same basis as employers and employees would create an additional incentive to misclassify workers as independent contractors.

These problems will become even more acute if the alliance structure in S. 1775 is made permissive or eliminated altogether, and if the employer mandate in that bill is eliminated in favor of an individual mandate. In such case, it might become necessary to designate a single government agency such as the IRS to administer the premium payment and subsidy requirements.

CONCLUSION

The proposed changes in the definition of employee for employment tax and other purposes raise important issues of tax and health policy and administration that deserve careful attention by Congress. We hope that these comments are helpful, and we will be pleased to assist the Committee and its staff further in any way we can.

SUPPLEMENTAL STATEMENT OF THE AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

[Tax Treatment of Partners and S Corporation Shareholders Under Proposed Health Security Act]

INTRODUCTION

The Section of Taxation ("Tax Section") of the American Bar Association ("ABA") respectfully submits the following comments on the tax treatment of partners and S corporation shareholders under the proposed Health Security Act, S. 1757, the Administration's health reform proposal. The comments are submitted solely on behalf of the Tax Section. They have not been approved by the House of Delegates or the Board of Governors of the ABA and should not be construed as representing the position of the ABA unless clearly stated.

The proposed Health Security Act (S. 1757) would amend Section 1402 of the Internal Revenue Code of 1986, as amended (the "Code") with respect to "net earnings from self-employment" of limited partners and shareholders of S corporations.

EXISTING LAW

Under existing law, Section 1402(a) of the Code defines "net earning from self-employment" to include a partner's distributive share of taxable income or loss described in Section 702(a)(8) (the non-separately stated items) from any trade or business carried on by the partnership. However, Section 1402(a)(13) excludes from "net earnings from self-employment" the distributive share of any item of income or loss of a limited partner (other than guaranteed payments to the *limited* partner for services rendered to the partnership.)[1]

There is no provision of existing Section 1402 that applies to shareholders of corporations, whether S corporations or C corporations. The employment tax treatment of employees of a corporation, whether or not they are also shareholders of the corporation, is dealt with under Section 3401 *et seq.* of the Code, relating to withholding of income tax with respect to wages, and Sections 3121 *et seq.* and 3305 *et seq.* of the Code, dealing with FICA and FUTA, respectively. In general, these provisions define "wages" as "all remuneration for employment." It has been recognized that a C corporation cannot escape its employment tax obligations by designating a shareholder-employee as an independent contractor. *Darrell Harris, Inc.* v. *U.S.,* 770 F. Supp. (W.D. Okla. 1991). Likewise, an S corporation cannot avoid its employment tax obligations by treating as dividends what are, in substance, wages to its employee-shareholders. *Rev. Rul.* 77-44, 1974-1 C.B.287, provides that an S corporation must withhold and pay FICA taxes, pay FUTA taxes, and must withhold income taxes on any distributions made to a shareholder for services rendered, whether or not the distribution is otherwise characterized as compensation. Courts have reached the same conclusion. *Radtke* v. *United States,* 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc.* v. *United States,* 918 F.2d 90 (9th Cir. 1990); and *Dunn & Clark, P.A.* v. *Commissioner,* Daily Tax Report (No. 85), May 5, 1994 (E.D. Id. 1994).

[1] Generally speaking, guaranteed payments are payments to a partner for services or the use of capital that are determined without regard to the income of the partnership.

PROPOSED CHANGES

S. 1757 would amend Section 1402 of the Code in the following respects:

1. *With Respect To Limited Partnerships.* Section 1402(a)(13) would be amended to exclude, from "net earnings from self-employment," only the distributive share of income or loss of a limited partner *who does not materially participate in the activities of the partnership.* The portion of existing Section 1402(a)(13) that requires that guaranteed payments with respect to services rendered to the partnership be included in "net earnings from self-employment" would not be changed by S. 1757.

2. *With Respect To S Corporations.* A new subsection (k) would be added to Section 1402 to provide that any individual, who is a 2-percent or greater shareholder of an S corporation which carries on a service-related business,[2] who materially participates in the activities of such S corporation, would have "net earnings from self-employment" equal to the shareholder's prorata share of the taxable income or loss of the corporation from such service-related business.

The stated reason for these amendments to Section 1402 with respect to limited partnerships and S corporations is to curb potential under-reporting of employment earnings for purposes of the premium discount rules of the Health Security Act. Moreover, in order to minimize administrative burdens on firms and not create an additional unfamiliar set of rules, the Health Security Act would utilize the existing employment tax provisions, as modified by the Act.

PROBLEMS WITH PROPOSED PROVISIONS

It is the position of the Tax Section that these proposed amendments are inappropriate and problematic for the following reasons:

1. *Existing Law with Respect to Corporations is Developing Adequately.* Existing provisions of the Code, as well as *Rev. Rul.* 74-44, *Radtke, Spicer,* and *Dunn & Clark, P.A.,* discussed above, require compliance with the employment tax withholding and payment provisions with respect to compensation paid to employees of corporations, whether S corporations or C corporations. Although there is more potential for abuse with respect to S corporations than C corporations in the employment tax area, because C corporations, in order to avoid the double taxation of earnings, tend to distribute net income as compensation rather than as dividends, there is no valid reason to treat employee-shareholders of S corporations as having self-employment income while treating employee-shareholders of C corporations as having wages from employment by the corporation. *Rev. Rul.* 73-361, 1983-2 C.B. 331 states that:

> Neither the election by the corporation [to be treated as an S corporation] nor the consent thereto by the stockholder-officers has any effect in determining whether they are employees or whether payments to them are "wages" for federal employment tax purposes. A corporation does not lose its identity by reason of such election but remains a legal corporate entity . . .

Furthermore, there is no valid reason to treat service-related businesses different from other businesses and, in effect, impute self-employment earnings to shareholder-employees of S corporations. If an S corporation has both a service-related business and a non-service related business, its shareholder-employees could be treated, as a result of the proposed legislation, as having both self-employment income and wages. To avoid duplication, the wage expenses would have to be allocated between the two types of activities and "self charging" problems would arise. This would increase the administrative complexity as well as the burdens on S corporations and their shareholder-employees in allocating and properly treating net income from the service-related business and the other business. The complexity would be exacerbated where a corporation has gone from a C corporation to an S corporation and vice versa.

2. *Inappropriate Distinctions Between Limited Partners and S Corporation Shareholders.* The proposed amendments make inappropriate distinctions between limited partners and shareholders of S corporations. The proposed amendment dealing with limited partnerships does not look at whether or not

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[2] "Service related business" is defined as any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of at least one of its employees.

a limited partner is a 2-percent or greater partner and does not apply solely to "service-related businesses." Thus, under the proposed provision, a limited partner who materially participates in the activities of the partnership, even if all of the income of the partnership is derived from capital, would have net earnings from self-employment equal to the partner's entire distributive share of income or loss described in Section 702(a)(8).

On the other hand, the proposed provision dealing with S corporations would apply only to individuals who own 2 percent or more of the stock of the corporation. Furthermore, net earnings from self-employment would include only the shareholder's prorata share of the corporation's taxable income or loss from the service-related business. There is no valid reason to make such distinctions between shareholders of S corporations and limited partners.

3. *Earnings From Capital Not Appropriately Taken into Account.* The proposed amendments do not appropriately exclude from "net earnings from self-employment" income derived from the use of capital in a partnership's or S corporation's trade or business. Although the proposed amendments with respect to S corporations would only require that a shareholder's prorata share of the taxable income or loss of the corporation from "service-related businesses" be taken into account as "net earnings from self employment," this provision would fail to exclude earnings from capital that is used in such service-related businesses, especially where the capital is a material income-producing factor.

TAX SECTION'S RECOMMENDATIONS

In light of these problems and concerns, the ABA Tax Section respectfully makes the following recommendations:

1. *Retain Existing Law Definition of "Net Earnings from Self-Employment."* Section 1402(a)(13), dealing with limited partnerships, should remain as it presently reads. It requires that a limited partner include, as "net earnings from self-employment," the limited partner's guaranteed payments for services rendered to or on behalf of the partnership. Thus, it insures that compensation to limited partners for services rendered to the partnership will be treated as self-employment income.

Furthermore, proposed Section 1402(k) should not be enacted. Existing law makes adequate provision for employment tax compliance by corporations with respect to compensation income paid to shareholder-employees. There is no reason to distinguish between employees of S corporations and C corporations as to their employment status. Furthermore, if enacted, Section 1402(k) would make unnecessary distinctions between limited partners and shareholders of S corporations as to their employment tax treatment.

2. *Exclude Earnings From Capital From "Net Earnings From Self-Employment."* If the Senate Finance Committee nevertheless determines that the self-employment provisions should be expanded from present law, the Tax Section recommends that income from capital employed in a trade or business should be excluded from "net earnings from self-employment," especially where capital is a material income-producing factor. There is ample precedent in the Code for distinguishing between service-related income and income from capital. For example:

A. Section 704(e), dealing with family partnerships, treats an individual as a partner for federal income tax purposes if he or she owns a capital interest in a family partnership in which capital is a material income producing factor. However, the distributive share of a donee partner may not include reasonable compensation for services rendered to the partnership by the donor partner. Furthermore, the donee's distributive share with respect to donated capital cannot be proportionately greater than the donor's distributive share attributable to capital. This provision is intended to curb assignment-of-income abuses in family partnerships. A similar provision, Section 1366(e), applies to S corporations.

B. If the Senate Finance Committee determines that a more objective standard than "reasonable compensation for services rendered" or "personal service income" is required, it should look closely, by analogy, to Section 911 dealing with the exclusion with respect to certain foreign earned income. Section 911(d)(2)(B) provides that in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered

as earned income. While the purpose of Section 911(d)(2)(B) is to limit the amount of foreign earned income that may be excluded from gross income, whereas the purpose of S. 1757 is to maximize self-employment income, a similar objective test could be applied for purposes of determining the amount of income attributable to capital for self-employment tax purposes under Section 1402. For example, the proposed statute could provide that in a limited partnership or S corporation that is carrying on a service-related business, where capital is a material income-producing factor, the net earnings from self-employment of a limited partner or shareholder who materially participates in the service related business shall include a reasonable amount of his or her distributive share or prorata share, as compensation for such partner's or shareholder's material participation in the service-related business, which shall in no event be less than 50 percent of the limited partner's or shareholder's distributive share or prorata share of income with respect to such service-related business. In this way, the role of capital as a material income-producing factor would at least be recognized, albeit in a mechanical and artificial manner.

CONCLUSION

The ABA Tax Section believes that the existing law as to the emploment tax treatment of employees of corporations, and the self-employment tax treatment of partners, is developing adequately. The Tax Section further believes that attempting to distinguish between service-related businesses and non-service related businesses of S corporations will create substantial and unnecessary complexities in determining the net income from each business. However, if the Senate Finance Committee determines that the self-employment provisions should be expanded from present law, the Tax Section strongly recommends that earnings attributable to capital of a limited partnership or S corporation, especially where capital is a material income-producing factor.

STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS

On behalf of the 16,000 member construction contractors, subcontractors and suppliers Associated Builders and Contractors (ABC) represents, I thank you for granting the opportunity to submit a statement for the record on the independent contractor issue in the Health Security Act, H.R. 3600.

ABC is a representative of small business, a sector of the economy that has already received a great deal of attention in the current health care debate. As the committee has heard many times, small business has been hit particularly hard by rising health care costs. Although ABC supports the basic tenets of the President's proposal—security, simplicity, savings, choice, quality and cost-sharing, we are troubled by some of the methods used to reach these goals.

As the esteemed members of the subcommittee know, the Internal Revenue Service has stepped up its worker-classification enforcement efforts in the past few years because it estimates misclassified workers cost the federal treasury over a billion dollars annually. There has even been considerable activity at the state level because of losses to state treasuries or workers' compensation programs from misclassification of workers.

ABC is committed to upholding proper business practices and commends you for holding this hearing on employee definition which includes the independent contractor classification issue. We are particularly concerned about this subject since the construction industry has been targeted by the IRS. The IRS has singled out construction because its research reveals patterns of noncompliance in this area. The industry, as a whole, faces a unique problem due to its high number of transient and seasonal workers.

ABC has heard loudly and clearly from some of our members harmed by independent contractor abuse. In construction, wrongful classification of employees can result in an unfair competitive edge. Those contractors who follow "proper" guidelines and pay federal and state payroll taxes, workmen's compensation, plus health insurance and pension contributions for their employees, can not compete with companies that unfairly use the independent contractor labor rates in the bidding process. This is certainly a clear example of "the consequences following from the misclassification of workers."

ABC believes, however, that it is incorrect to assume that all independent contractors are "misclassified." In the small business world, independent contractors are often the perfect answer to providing special skills and know-how needed for short term projects. Because of the cyclical nature of the construction industry, many in

the business could not afford to keep certain specialized trade craftsmen as "employees." The flexibility an independent contractor provides to a small, fledgling operation creates numerous advantages for all parties involved. This arrangement allows the independent contractor to have the freedom to choose his or her work schedule, a small business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced, quality product. Forcing all or some individuals to be reclassified as employees would have serious negative effects on the small business community.

Under the current IRS practice of using 20 common law factors to determine an employee classification there is a lot of room for guesswork. The vague guidelines and their inconsistent application leaves much to be desired. If Congress or the IRS is serious about cracking down on abuse, perhaps the time has come to acknowledge the validity of independent contractors in the workplace, provide a workable definition and set of rules for both independent contractors and employees and enforce them across the board

ABC is concerned about provisions of the Administration's Health Security Act proposal that revise current income and employment tax provisions relating to the classification of individuals as employees or independent contractors. In general, these provisions grant the IRS more power than Congress, make a regulation more powerful than legislation, and give the IRS extraordinary authority to not only define an "employee" or "independent contractor" for health care purposes but also for employment purposes and income taxes. Specifically, the package repeals current law that prohibits Treasury from issuing regulations on the classification of "employees." Also, it requires Treasury to issue regulations to determine whether an individual is classified as an employee for employment and income tax purposes. The proposal states that Treasury regulations on the classification of "employees" will override current statutes and rules on the classification of employees. Also, under section 530, current safe harbor provisions would be repealed and replaced with less favorable ones. The new safe harbor rules make it more difficult for employers to rely on "prior IRS audit" and "long-standing industry practice" safe harbors to classify individuals as independent contractors.

ABC has submitted testimony to the House Ways and Means Committee numerous times on the independent contractor issue and the need for reform of the common law test that determines worker classification. We believe the sweeping changes embodied in the Clinton health care plan gives the IRS far too much power; that this is an inappropriate place to address this complicated issue; and their inclusion sets a dangerous precedent that needs to be curbed.

On behalf of Associated Builders and Contractors, we greatly appreciate the opportunity to offer our views on the classification of workers as independent contractors under the Health Security Act. As health care reform issues are addressed by your committee, ABC looks forward to working together with you and your staff regarding the concerns of the construction industry and small business.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America (AGC) is a national trade association comprised of more than 33,000 firms, including 8,000 of America's leading general contracting companies. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, multi-family housing projects and site preparation/utilities installation for housing development.

Many AGC member firms routinely and legitimately contract with independent contractors to perform work in all states and many different localities. Independent contractors add to the value of vigorous competition on construction projects in every market. We submit this statement to the committee because of a provision in the Administration's health care proposal that would jeopardize general contractors ability to use independent contractors.

Our statement is limited to the employment status provisions of the Administration's Health Security Act, under Title VII, Subtitle C (pp. 1119-1127). Subtitle C amends the Internal Revenue Code by adding new sections to the employment tax section—independent contractors would be virtually eliminated. This provision encompasses change beyond that of simply reforming the nation's health care system. AGC is greatly concerned about the employment tax provisions in Subtitle C.

SUBTITLE C WOULD OVERRIDE ALL CURRENT CLASSIFICATION STANDARDS

- The Act would direct the Secretary of the Treasury to issue regulations defining who is an "employee" for federal employment and income taxes. The IRS would

be given the authority to unilaterally write the rules regarding the classification of an individual not only for health care benefit purposes, but for all employment tax purposes;

- the Act would repeal Section 530, and replace it with a new, less favorable safe harbor that would limit the ability of employers to rely on past IRS audits and long-standing industry practice as criteria for classifying workers as independent contractors; and
- includes increased penalties for taxpayers who fail to file accurate information returns involving payments for services.

Additionally, the classification of an independent contractor will be deemed correct only if the employer has *not* been notified in writing by the Treasury Department before the beginning of the employment period to treat the worker—or any individual in a substantially similar position—as an employee.

BACKGROUND

Worker misclassification is an old issue both for the IRS and employers. It has been the subject of numerous hearings in this committee and other Congressional committees, extensive litigation, as well as the topic of a 1992 GAO report (GAO/GGD-92-108, July 23, 1992; *Tax Administration: Approaches to Improve Independent Contractor Compliance).* Yet, the issue remains unresolved.

A variety of occupational relationships and job classifications exist in the American workplace and in the construction industry. However, for Federal tax purposes only two classifications exist: a worker is either an employee or an independent contractor (i.e. self-employed). Significant tax consequences result from how a worker is classified; some of the tax consequences favor employee status, while others favor independent contractor status.

Section 530 exists because Congress realized that independent contractors contribute a vast amount of added value to economic production and because it is not fair to change the rules after taxpayers organize their affairs according to good faith reliance on industry practice or prior IRS determinations. Congress enacted these protections for a number of reasons, but it is safe to say the legislative history of Section 530 supports the view that taxpayers are to be afforded significant latitude in asserting or maintaining independent contractor status.

Congress statutorily prohibited the IRS from writing the rules on employment status in Section 530 of the Revenue Act of 1978. A reversal of this prohibition, which was intentionally imposed on the IRS, would constitute a major change in Congressional policy with regard to the independent contractor issue. The IRS was not allowed to write the rules for a very good reason—due to the magnitude of the change, neither the business community nor Congress was willing to trust the IRS to do it on their own.

Specifically, these protections were established because: individuals not under the control of others in the workplace bear all the risk and expense for their employment; they were increasingly vulnerable to IRS reclassification as employees subsequent to prior audits in which their treatment as independent contractors had not been challenged and after private letter rulings or technical advice memoranda from the Service had said that they were independent contractors; or after they had relied on common industry practice.

In its original General Explanation of Section 530 in the Revenue Act of 1978, the Joint Committee on Taxation stated that Section 530 was enacted to protect certain classes of taxpayers from IRS reclassification of independent contractors as employees. The General Explanation says, "workers shall be deemed not to be the taxpayer's employees, unless the taxpayers had no reasonable basis for not treating the workers as employees."

The Joint Committee on Taxation further explained that the Revenue Act of 1978 terminated pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Clearly, the legislative history of this provision establishes that Congress acknowledged that certain taxpayers have a legitimate basis for using workers not considered as traditional employees.

This "reasonable basis" standard has been the guiding principle behind worker classification since 1979. If there is any confusion about Congress' intent with regard to the issue of classification, any ambiguity is removed by the statement in the General Explanation that "Congress intends that this reasonable basis requirement be construed liberally in favor of taxpayers."

In other words, Congress intends that taxpayers (including general contractors) who use independent contractors are to be afforded the benefit of the doubt. This presumption in favor of the taxpayer is initially accomplished through the creation of three statutory reasonable basis standards, or safe harbors.

FOR EXAMPLE

Consider a situation common to thousands of construction sites throughout the country. Individuals contract for short periods with one or more construction companies to perform certain work on construction projects. These individuals own their own trucks. They own their own tools. They pay into their own retirement plans. They are not told when to report to work, or how to perform the work. And other contractors in the general geographic region are free to contract with these individuals, or others like them, to perform the same type of short term work.

By any objective standard, these individuals are not employees of the general contractor. Without the current Section 530 protections, the Federal government may determine that they are, even after both parties had relied on historic industry practice or on prior IRS advice. If the government successfully prevails in a reclassification case against the independent contractor, that individual is then subject to withholding, social security and unemployment taxes—none of which had been withheld (retroactively), nor paid to the Treasury.

Under Subtitle C, though, the rules would be changed making it more difficult for employers to classify workers as independent contractors. Further, mandating that they withhold for health insurance purposes for all workers, suddenly and irreversibly opens the door to future withholding requirements for all other employment taxes as well.

CONCLUSION

It is unrealistic to expect that the employment tax changes recommended as part of the Health Security Act will not significantly alter which workers are classified as employees of a business for health coverage and other purposes. The argument that this provision would avert a possible rush by employers to shift workers classified as employees, reclassifying them as independent contractors is overly simplistic.

While the assertion that employers will game the system if the current rules are left in place may have a modicum of truth, removing Congress from the rule-making process and granting the IRS carte blanche to develop employee classification rules tips the scales too far in favor of the Executive Branch. Giving the IRS the ability to treat any worker as an employee would take control away from employers, placing squarely on their shoulders full responsibility for all employment taxes, in addition to any new health mandates. In the past, Congress has not abrogated its authority in such a manner to the Executive branch.

General contractors and others who use independent contractors, have been concerned for a long time about the problems associated with worker misclassification. In fact, AGC has been working with the IRS for the past two years to resolve differences related to the 20 factor common law test used by both the Service and the construction industry to determine proper worker classification. If Subtitle C in the Health Security Act is enacted, however, the pendulum will have swung too far. In fact, a simple summation on the effects of Subtitle C would be that the Treasury Department gets the final word on everything. We hope this will not be the case.

The current law and rules for classifying workers for purposes of federal employment taxation are adequate. Any remedial changes should be accomplished by improving the administration and enforcement of current law. A greater awareness and implementation of an educational program to inform independent contractors and taxpayers that purchase services from independent contractors about their obligations under federal tax laws will alleviate confusion. Health care reform legislation must not be used as the vehicle to change employment law—too much is at stake and ultimately too much authority would be turned over and centralized in the Internal Revenue Service.

This provision was not necessarily drafted as a result of the need to increase collections, so much as a desire by the Internal Revenue Service to more easily and efficiently collect revenues. While this is an attempt to streamline IRS's collection system, it would be instituted at great cost to employers. Congress must act with prudence in crafting a solution. We and others have examined this provision. Even a cursory look shows dimensions of Subtitle C that the drafters probably had not conceived including the relationship of a federal definition of employee, that could later be incorporated by states for workers compensation programs, ADA, the National Labor Relations Act, and other federal labor laws.

The Associated General Contractors of America greatly appreciates the interest of the Chairman of the Finance Committee, and the opportunity to provide the Committee the views of general contractors at this stage in the debate on health care reform. AGC offers our pledge to work with the you and others in Congress to address this critical issue, but ask that you delete or at the very least substantially change Subtitle C.

Thank you.

STATEMENT OF THE AMERICAN TRUCKING ASSOCIATIONS, INC.

INTRODUCTION AND SUMMARY

The American Trucking Associations (ATA) is the national trade association of the trucking industry. Classification of workers as employees or independent contractors is a major concern in the trucking industry, and we appreciate the chance to offer our views on that issue in the context of health care.

The Health Security Act (S. 1757) would: give the Treasury Department authority to issue regulations classifying workers as employees or independent contractors; increase penalties for failure to issue accurate Form 1099–Misc information returns to independent contractors; and curtail or repeal the various safe harbors under section 530 of the Revenue Act of 1978.

- ATA favors keeping the current ban on Treasury regulations. We believe the strong body of court decisions and other common law, plus the safe harbors of section 530, give most taxpayers in our industries sufficient certainty as to who is an independent contractor. Past IRS efforts to write employment regulations make us apprehensive that long-standing, legitimate relationships would be jeopardized.
- We share the Administration's concern that some individuals may try to "game the system." We believe these concerns are best addressed by improving compliance, not by reclassifying whole groups of workers and creating uncertainty for others.
- We have engaged in many educational initiatives on our own and in cooperative efforts with the IRS to improve compliance and understanding of an inherently complex issue.
- We believe the IRS should make better use of existing data before raising penalties on employers. Specifically, we recommend that Schedule C be modified so that IRS can match information it receives from Form 1099-Misc with amounts reported by independent contractors.
- We agree in principle with the Administration that a worker's classification for tax purposes should also apply for health care, but such a principle does not justify the Administration's overly broad and threatening approach. We stand ready to work with Congress and the executive branch to achieve more constructive solutions.

BACKGROUND

ATA is a federation comprising 30,000 trucking companies and suppliers that belong directly to ATA or its 51 state and 11 specialized national affiliates. ATA includes motor carriers of all sizes and types, ranging from single owner-operators to major companies that employ drivers, contract with owner-operators, or both.

Independent contractors play a vital role in several segments of trucking. Independent contractor drivers are small businesses that buy and operate their own equipment and pay all of the costs of such businesses, including fuel, maintenance, labor, bookkeeping and taxes. Such businesses are specifically recognized by Congress in the Interstate Commerce Act (49 U.S.C. 11107) and regulations of the Interstate Commerce Commission (49 CFR 1057). As independent business people, they make their own decisions as to what shipments to handle, what routes to take, and what business and personal expenses to assume and which to insure against, including health care costs.

INDEPENDENT CONTRACTORS UNDER S. 1757

The Administration has proposed language in the Health Security Act (S. 1757) that would put the future of independent contractors in doubt. We urge rejection of this proposal.

Specifically, section 7301 of S. 1757 would give the Treasury Secretary authority to issue regulations prospectively classifying workers as employees. "Significant weight" is to be given the common law classification of workers, but only a few types of workers would be beyond the reach of reclassification by regulation: direct sellers and real estate agents, who are non-employees by statute, and a few classes of statutory employees.

Section 7302 would increase penalties for service recipients that fail to issue 1099s or that issue incorrect 1099s. Section 7303 would put into the Internal Reve-

nue Code parts of section 530 of the Revenue Act of 1978 but greatly limit businesses' ability to use the section's current safe harbors.

WHY CONGRESS SHOULD LEAVE EMPLOYEE CLASSIFICATION AS IS

Administration officials have met with ATA and tried to provide assurance that they do not plan any radical overhaul of the definition of employee. They have stated that the purpose of section 7301 is solely to prevent employers from "gaming the system" or switching employees to independent contractor status. But these assurances are unconvincing for two reasons. First, however "moderate" current officials may be, they cannot bind their successors. Second, previous efforts by the IRS to define employees for various purposes have had alarming results, as detailed in the following examples.

Pre-1978 experience. Before enactment of section 530 of the Revenue Act of 1978, many trucking companies were audited by the IRS. Workers were not simply reclassified but, all too often, businesses were closed and personal assets seized. Although audits have continued, and businesses that have misclassified workers may be forced to change their practices and/or pay taxes and penalties, section 530 has brought much greater security to businesses that have treated workers as independent contractors in good faith. Treasury now proposes to abolish that measure of certainty.

Employee leasing rules. Treasury proposed rules in 1987 that would have forced trucking companies to treat thousands of independent contractors (even ones acknowledged by the IRS as such) as "leased employees" for pension and other benefits purposes. Senator Pryor and others on this Committee have tried ever since to fix these problems. Recently the House Ways and Means Committee noted, "The leased employee rules are *complex and have unexpected and sometimes indefensible results, especially as interpreted under regulations proposed by the Secretary.*" (H. Rept. 103–353, p. 32, accompanying H.R. 3419, Tax Simplification and Technical Corrections Act of 1993; emphasis added)

We can understand and sympathize with the complex issues facing Treasury. In light of these and other attempts by Treasury to define employees for various purposes, however, we ask you to recognize our concerns regarding the prospects of massive reclassification. We urge you to leave current law alone.

Current law works. Despite complaints and "horror stories" regularly trotted before committees that have held hearings on employee classification, there are many industries in which the current, common law approach to classification works well. For instance, in trucking there is a long history of case law, including Supreme Court decisions, establishing conditions under which drivers are independent contractors. ATA has worked hard to educate our members regarding classification criteria. We have also worked with IRS and Treasury staff on a number of initiatives to improve certainty and compliance.

"Current law" does not imply an absence of guidance. The IRS issues hundreds of private letter rulings and technical advice memoranda per year, and courts continue to rule on employment classification cases. In fact, it is the very continuity of current law that makes it the best solution for an inherently complicated problem.

This process can be augmented by cooperative efforts such as Compliance 2000. At Treasury's invitation, an ATA affiliate, the American Movers Conference (AMC), has been involved for over a year and a half with the IRS in a Compliance 2000 project, under which household goods movers have met with IRS personnel to discuss audit procedures for the tax treatment of drivers. Although Compliance 2000 is not the sole solution to the problems facing this Committee, it is an example of how this industry has worked for improved tax compliance and certainty. S. 1757 would negate these efforts and destroy whatever certainty now exists.

HOW TO IMPROVE COMPLIANCE

As we have argued before, the real difficulty is not with the present method of classification, but with selected compliance problems. Indeed, even Treasury says that it wants to give "significant weight" to the common law but that it is concerned about compliance. Treasury officials have explained that they included sections 7301-03 in S. 1757 for two reasons.

First, an overriding goal of the health care reform initiative is to assure health coverage for every American. The Administration has chosen to pursue that goal by mandating that employers pay a premium for every employee. To ease the burden of premiums on small employers of low-wage workers, the Administration would offer "subsidies" in the form of lower premiums based on average wage and number of employees. Both the mandatory premium and the discount create incentives for

employers to "game" the system (minimize the number of employees, spin off or "lease" high-wage employees, etc.). Therefore, Treasury wants to be able to decide by regulation whether certain categories of workers are employees.

Second, having made such determinations for health care purposes, Treasury wants to apply the same definitions for employment and income tax purposes, for the sake of administrative simplicity and to further limit "gaming."

Many employer and independent contractor representatives believe that an unstated but equally important objective of IRS officials is to maximize the number of workers treated as employees for ease of tax collection.

We believe it makes more sense to target enforcement on suspected problem areas than to jeopardize the status of all independent contractors through sweeping regulations. The Treasury itself noted in its 1991 report, "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986," that compliance can be as high for some independent contractors as for employees.

Making better use of Schedule C. Specifically, ATA for several years has proposed measures to improve tax compliance by independent contractors. In repeated meetings with Treasury and IRS officials, we have urged two simple changes to Schedule C of IRS Form 1040 that would lead to a number of benefits for compliance:

- Require individuals to list their total self-employment income separately from other receipts.
- Require that they list the amount paid by each service recipient and the payor's name.

The IRS would then be able to match the total from Schedule C against the amounts the IRS had posted on the individual's master file. Where a discrepancy existed, the IRS could see which payors were omitted from Schedule C. This process has worked well for a decade in boosting compliance on dividend and interest income. The process would enable the IRS to target and resolve discrepancies much more efficiently and less intrusively than is presently possible.

Because self-employed individuals would be eligible for the largest reduction in employer premiums, identification of their self-employment income is especially important under the Administration's plan. The above suggestion would make such identification much easier.

Penalties. Many penalties in the tax code have been increased in the past decade, yet both IRS officials and outside researchers have expressed doubt about the value of increasing penalties in general. We urge the Committee to seek evidence that the proposed penalty increase would be useful in boosting compliance before adopting it.

CONSISTENCY

The Administration argues that consistency is needed in determining who is an employee for health care and tax purposes. The IRS must make this determination for tax purposes anyway (assuming the agency is not going to follow the decisions of each regional alliance). Furthermore, there is a long history of both agency practice and court decisions to guide businesses and individuals in making the determinations.

We agree in principle with the Administration that consistency in defining workers for different purposes is desirable. As multistate companies, our members already face a plethora of laws defining employment status for federal and state employment tax, income tax, benefits, labor standards and workers' compensation purposes. But the Administration's "solution" would overturn an area of law that is reasonably well settled for many employers and impose a regime of letting Treasury rewrite the definition in a way that may not conform to any existing standard. We think it makes more sense to have the health care definition of employee match the existing federal tax practice. Incidentally, this is what White House health care advisor Ira Magaziner said would be the Administration's position last fall.

Therefore, we recommend that section 530's safe harbors be amplified to cover health care and income tax as well as employment tax.

CONCLUSION

The Administration's proposals regarding classification of workers under the Health Security Act appear to reflect mixed motives. We believe their goal of consistent treatment of workers for health care and tax purposes is sensible. But the goal can best be met by leaving existing definitions and practices alone rather than by allowing Treasury regulations writers to overturn decades of precedent. The goal of improving compliance can best be achieved by making better use of existing data rather than by increasing penalties for 1099s.

STATEMENT OF THE COALITION FOR INDEPENDENT CONTRACTORS

I am Edward N. Delaney of Edward N. Delaney & Associates, Chartered, Washington, D.C., and I am submitting these comments today on behalf of The Coalition For Independent Contractors (the "Coalition").

The Coalition submits this statement on behalf of the American Pulpwood Association, the Associated Builders and Contractors, the Associated General Contractors of America, the National Association of Independent Insurers, the National Association of Realtors, and the Newspaper Association of America.

The Coalition opposes the provisions contained in the Administration's health care reform proposal, the Health Security Act (the "HSA"), that would change the rules for determining who is, and who is not, an "employee" for purposes of health care coverage and federal income and employment taxes, because such provisions:

- would limit an individual's right to work as an independent contractor;
- do not meaningfully address the alleged abusive practices that they were intended to prevent;
- do not advance any identifiable tax policy objective;
- could result in independent contractor status being constantly narrowed, as a means of stemming government health care expenditures; and
- would cause severe disruptions in the market for freelance talent.

I. A Frontal Attack On Independent Contractors

In plain, simple terms, the changes proposed by the HSA to the definition of "employee" and to the section 530 safe harbor provisions of the Revenue Act of 1978 (collectively, the **"Independent Contractor Proposals"**), represent a direct assault on an individual's right to work as an independent contractor.

For example, the Coalition finds it astonishing that the HSA would permit the Treasury Department to redefine the term "employee " -- in light of the Internal Revenue Service's institutional bias against independent contractor status. The bias is so pronounced that in connection with the Revenue Act of 1978, the Congress expressly proscribed the Treasury Department from issuing any regulation or Revenue Ruling "clarifying the employment status of individuals for purposes of the employment taxes." *Section 530(b).* The HSA would effectively authorize the agency that the Congress recognized back in 1978 as harboring a strong bias against independent contractor status to rewrite the rules for determining a worker's status.

The taxpayer's perception of the IRS was aptly described in an op-ed article that appeared in the April 7, 1993, Wall Street Journal:

> The Internal Revenue Service is carrying out a sweeping campaign to slash the number of Americans permitted to be self-employed -- and to punish the companies that contract with them. The IRS's attack has devastated thousands of small businesses and is undermining high-tech industries, the health-care industry and even freedom of religion. IRS officials indicate that more than half the nation's self-employed should no longer be allowed to work for themselves.

The Coalition submits that in light of this long-standing bias against independent contractors, a proposal that would authorize the Treasury Department to redefine "employee" represents a clear policy objective to limit substantially an individual's right to work as an independent contractor.

II. As An "Anti-abuse" Provision, The Independent Contractor Proposals Miss The Mark

The **Independent Contractor Proposals** do not meaningfully address the allegedly abusive practices they are intended to prevent; they appear aimed at some objective separate from health care reform; and they unfairly single out potential independent contractor reclassification as the only anticipated abuse -- of the several identified -- to address.

The Joint Committee on Taxation, Description and Analysis of the Employer Mandate and Related Provisions of H.R. 3600 ("Health Security Act") (JCS-1-94) 102, February 2, 1994 ("Joint Committee Report"), indicates that the **Independent Contractor Proposals** were contained in the HSA in order to preclude businesses from being able to "re-employ some existing employees as independent contractors." If this is true, why would the HSA repeal section 530?

Section 530 provides absolutely no protection with respect to any worker who has been "treated ... as an employee for any period." *Section 530(a)(1)(A)*. Section 530 protection is also denied with respect to the:

> treatment of any individual for employment tax purposes ... if the taxpayer (or predecessor) has treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after December 31, 1977.

Section 530(a)(3) (Emphasis added). The foregoing demonstrates that section 530 currently prevents the very same abuses that the HSA would repeal section 530 to prevent. It follows that the rationale for repealing section 530 is at best "logically challenged."

With respect to the Treasury Department being authorized to draft a new definition of "employee," the Coalition submits that if the true motivation for modifying the definition is to prevent "abuse" of the new health care system, the new definition would be set forth in the statute, and it would become effective concomitantly with the statute. The fact that the new definition would become effective at some time independent of when the HSA becomes effective appears to indicate that the definition is being modified to achieve some policy objective separate from health care reform.

The Joint Committee Report also identifies other ways in which firms would be expected to "abuse" the new health care system. For example, firms would be expected to "out-source" janitorial needs and legal and accounting services, thereby reducing the size of the firm's employment and possibly qualifying the firm for a government subsidy. *Joint Committee Report at 102.* Similarly, firms would be expected to "split up" into two or more smaller firms, in order for the new, smaller firms to qualify for a subsidy. *Id.* Other examples are also mentioned. While the Joint Committee Report lists several abusive practices that are anticipated to follow the HSA's enactment, the HSA's anti-abuse provisions address only the feared reclassification of employees to independent contractors status.

At best, the **Independent Contractor Proposals** represent a failed attempt at proscribing anticipated abuses and unfairly single out independent contractors as the only source of potential abuse to be addressed. At worst, the proposals represent a discriminatory attack on independent contractors with no plausible justification.

III. No Tax Policy Justification For Independent Contractor Proposals

If eliminating health care abuses were the true objective, why extend the **Independent Contractor Proposals** to apply also for purposes of Federal income taxes and Federal employment taxes? If the **Independent Contractor Proposals** are intended to achieve some tax policy objective, the proposals should be debated in that context, not within the context of eliminating some type of health care abuse.

The Coalition submits that the Treasury Department Report on Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986 ("Treasury Report") demonstrates that tax policy considerations would favor retaining the status quo. The Treasury Report concludes that:

> Current law does not consistently favor status as either an employee or an independent contractor.

Treasury Report at 12. In this regard, the Treasury Report also points out that:

> Prior to 1982, compensation earned by independent contractors was taxed at substantially lower rates under the Social Security and Medicare tax provisions of the Code than wage income, apparently creating significant incentive for misclassification. Subsequent legislation has essentially eliminated this important difference.

Id. Thus, while at one time the tax law might have provided a tax incentive to prefer independent contractor status over employee status, the law has been changed, and clearly no such alleged incentive remains. The report also concludes that:

> With typical patterns of fringe benefits and worker expenses, independent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than employees and employers, provided that the income and expenses are reported correctly.

Treasury Report at 24. Hence, not only does current law not provide a preference for independent contractor status over employee status, it actually provides a preference in favor of employee status.

The Treasury Department Report demonstrates that current law has created a state of equilibrium with respect to a taxpayer choosing to work as an employee or an independent contractor. The Coalition urges that this equilibrium not be disturbed absent some compelling policy justification. As demonstrated above, none of the purported justifications for the **Independent Contractor Proposals** would qualify as meritorious, much less compelling.

IV. Independent Contractors Could Become The Scapegoat For Eliminating Revenue Shortfalls

Another reason for concern over the Treasury Department being empowered to rewrite the law defining "employee" derives from the new tensions that the HSA would impose on the distinction between employee or independent contractor classification, and the pressure those tensions could impose on the Treasury Department to constantly expand the definition of "employee." The new tensions would result from the fact that, under the HSA, a subsidy could be obtained in some cases by converting employees to independent contractor status.

Since government subsidies are ultimately paid for by taxpayers, the aggregate amount of the government's HSA subsidy in any given year could become a significant concern. The Coalition anticipates that if the aggregate HSA subsidy for a year were to exceed its projected amount, some might urge the Treasury Department to reduce the amount of future subsidies by expanding the definition of "employee." The Treasury Department would have the authority to do so under the HSA without Congressional approval. Such an action would make it more difficult to convert employees to independent contractors, thereby possibly limiting the availability of HSA subsidies.

The Coalition is gravely concerned that, under the HSA, independent contractors could one day become the scapegoat for spiraling increases in government expenditures for health care, and their ranks thinned in the name of reducing the level of government HSA expenditures. The discretion given to the Treasury Department under the HSA, together with government HSA subsidies that arguably would be associated with independent contractor status, would leave independent contractor status extremely vulnerable.

V. Real Life Consequences Of Independent Contractor Proposals

The Coalition is concerned that the HSA changes to the worker classification rules would likely result in the freelance marketplace being restructured in a way that would impose added costs on freelance workers.

We are familiar with an actual case where the IRS audited a business and required the business to reclassify its independent contractors to employee status. Nearly all of the erstwhile

independent contractors terminated their relationships with the business. The individuals simply refused to relinquish their independence.

The Coalition is gravely concerned that the **Independent Contractor Proposals**, by eliminating virtually all of a business's defenses against an overly aggressive IRS reclassification effort, would result in a massive reclassification effort being waged by the IRS. It is submitted that such a reclassification effort would, in turn, result in a gradual elimination of most types of independent contractors.

This specter would introduce an intolerable level of uncertainty into the current market for freelance talent. By permitting the Treasury Department to modify the rules for distinguishing employees from independent contractors, the HSA would effectively preclude businesses from being able to plan with any certainty how to obtain needed service providers for ad hoc projects requiring unique talents not available "in house." Businesses would know that the worker classification rules were subject to change, but they would not know when the rules would be changed, and they would not know what the new rules would provide. Businesses would likely react by reducing their reliance on independent contractors.

The effect on individuals who now choose to work as independent contractors would be dramatic. While policy makers might believe that the changes would result in freelancers becoming employees of their clients, we submit that such a prediction represents a misunderstanding of why individuals choose to work as independent contractors. The Coalition believes that the changes would more likely result in the erstwhile independent contractors becoming affiliated with employee leasing firms, or some variant thereof, to enable them to retain some semblance of the independence on which they thrive, while avoiding the stigma that would become associated with independent contractor status. As demonstrated by the anecdote recounted above, many individuals would refuse to work as a captive employee of any one business.

The transformation from independent contractor to leased employee carries with it an added cost. An employee leasing firm is itself a business. Employee leasing firms charge a price for admission to its ranks. The burden of the admission cost would ultimately be borne 1) by the worker, in the form of a reduced net earnings from a project, or 2) by the client, who would either (a) pass it on to its customers in the form of higher prices for its products or services, or (b) absorb it internally through reduced net profits. Neither option represents wise economic policy.

At a time when technology has enabled workers in Ireland to be awarded contracts to perform the services required by "back room" operations of major United States financial houses -- for a fraction of what it would cost for United States workers to do the work, and other foreign-based workers now vying for contracts to perform software development and other types of services that formerly were limited predominantly to United States workers, does it make any sense for the government to impose an added cost on the use of United States service providers? It is respectfully submitted that such a policy defies common sense.

We believe that especially in today's economic climate, where United States workers are scrambling to compete against their foreign-based counterparts, the government should be helping them, not throwing obstacles in their path.

VI. Conclusion

For the foregoing reasons, the Coalition opposes the changes to the rules for determining a worker's status. The changes are not properly aimed at the abuses sought to be guarded against; they lack any tax policy justification; they would create an intolerably uncertain environment for independent contractors and users thereof; and they would introduce into the nation's labor market dramatic distortions with no perceptible gain to society.

Finally, if the Congress deems it appropriate to act in this area, it should clearly articulate its justifications for the changes, debate them on their true merits, and include the specific changes in the proposed legislation, not leave the specifics to an administrative agency. The Coalition submits that no change of this magnitude should be cast as a mere anti-abuse measure tied to an overshadowing health care reform proposal.

Statement of the Construction Financial Management Association

I am the National Secretary of the Construction Financial Management Association (CFMA) and it is in this capacity that I am writing you today.

CFMA was established in 1981 and represents more than 5,000 financial managers in the construction business. CFMA members are employed by over 2,000 construction companies across the U.S., more than one-third of which have gross annual revenues ranging from $25—$99 million. On behalf of CFMA, I would like to thank you for the opportunity to submit written comments on the independent contractor issue—an issue important not only to our members, but to the entire construction industry.

We understand that Congress faces a monumental task in reviewing the numerous and complex proposals contained within President Clinton's "Health Security Act." We know that you will scrutinize these proposals very carefully and encourage you to consider the economic contributions and unique requirements of the construction industry as you evaluate the independent contractor provisions of this bill.

THE CONSTRUCTION INDUSTRY AND THE U.S. ECONOMY

Construction accounts for almost 8 percent of the entire gross national product and employs close to 5% of the entire workforce. Construction, therefore, is one of the major driving forces behind the economy. It represents one of the main sources of future economic growth and reflects the health of the national economy as a whole. (It is important to note that since 1990, 750,000 jobs have been lost within the industry, representing more than 10 percent of the entire workforce.)

HOW THE CONSTRUCTION INDUSTRY REALLY WORKS

The Organizational Structure

Each construction project involves an amalgamation of independent economic entities that come together under unique and complex legal arrangements for a specific job and then disperse.

These entities are a combination of corporations, partnerships, and sole proprietors who join together as:

- general contractor,
- subcontractors,
- first-tier subcontractors/second-tier subcontractors, and
- suppliers/vendors.

For example, a typical industrial building project might involve a general contractor with between 15–20 subcontractors specializing in excavating and foundation work, structural steel erection, floor laying, mechanical/electrical/heating work, plumbing, drywalling, carpentry, roofing and sheet metal work, concrete work, plumbing, paving, etc. An example of a first-tier/second-tier subcontractor relationship would be the mechanical subcontractor who subcontracts out to a plumber to do the underground piping for the electrical wiring.

It is important to note that these specialty trade subcontractors are independent contractors, hired on a project-by-project basis for short durations and certain limited assignments; they also work multiple jobs simultaneously with different general contractors.

To further complicate the situation—owners, architects, construction managers, and consultants may also be involved in the direction and coordination of activities on a jobsite, including the selection of subcontractors. Further, there are occasions when more than one prime contract is being executed at a site with cross utilization of subcontractors between and among general contractors, owners, and others.

The Project Structure

Because of the unique nature of construction work, each project involves a different mix of participants whose methods of operation vary. For example:

- A general contractor's involvement in a project can range from an overall administrative role to controlling all details of the job.
- Some entities may operate at the construction site, others may be offsite.
- Construction work is usually incremental so that various aspects of the job are done by different entities at different times; also, the same entity may be on the jobsite at different times, with significant time gaps in between.
- The contracts involved may be fixed-fee, lump-sum, cost-plus, time and material, or labor-only agreements.

PRESIDENT CLINTON'S "HEALTH CARE ACT"

President Clinton's health care bill would hit the construction industry broadside on three fronts. First, it would require the IRS to define who is an employee and who is an independent contractor. Second, this bill would eliminate the section 530 "safe harbor" as it relates to long-standing industry practice, thus forcing radical changes in the way the construction industry operates. Third, the scope of the new rules governing the classification of workers would also extend to federal income and employment taxes.

CONGRESS SHOULD DECIDE

CFMA opposes giving the IRS statutory authority to modify the rules on classifying workers, not only for health care purposes, but for all employment/income tax purposes.

Congress has had the sole authority to govern the classification of workers since 1978 because of the controversies that developed between the business community and the IRS over the independent contractor issue. If this provision is enacted, it would constitute a major shift in power from Congress to the IRS and a dramatic change in congressional policy on the independent contractor issue.

CFMA believes it would be a serious error to give the IRS such sweeping authority to determine who is and who is not an employee, thereby reversing the prohibition on regulatory action originally and intentionally imposed by Congress on the IRS.

(However, should this provision become law, CFMA recommends that the legislation include an amnesty provision covering those who complied with section 530 prior to the new law.)

BACKGROUND ON SECTION 530

Congress adopted section 530 of the Revenue Act of 1978 because the rules on the classification of workers as "employees" or "independent contractors" were imprecise and because increased numbers of employment tax audits lead to increased controversies between the IRS and the business community. Section 530 was a stopgap measure to give Congress time to produce a permanent solution to the complexity of the independent contractor issue and to reduce the level of controversy. Congress has made some progress on the issue, but Congress has also learned the lesson learned earlier by the business community and the IRS: this is a hard problem to solve.

Congress acted on the issue in 1982. Statutory standards were adopted for two types of workers: direct sellers and real estate agents. (If these standards are met, these workers are treated as independent contractors.) But Congress also decided—as part of the same 1982 legislation—to extend section 530 for everyone else. Clearly the decision was to simplify and clarify the law where possible and to leave everyone else as is. Congressional actions in 1978 and in 1982 clearly indicate that section 530 was intended to help taxpayers.

RETAIN SECTION 530 "SAFE HARBOR" RELIEF

Another major component of the President Clinton's health care plan is the repeal of section 530 "safe harbor" relief based upon long-standing industry practices.

As I have just described, the construction industry has long relied on **contractor/subcontractor** and **subcontractor/subcontractor** relationships. It must continue to rely on these relationships because:

- The requirements of each particular project differ so dramatically as to the **scope of work to be performed,** the **degree of skills needed,** the **number of disciplines to be engaged,** and the **human resources to be allocated.**
- Therefore, general contractors cannot afford to hire the number and **variety of trade specialists** they need as full-time (or even part-time) employees.
- Construction work, by its very nature, is **cyclical, unpredictable, intermittent,** and **non-repetitive.**

The Worst Case

If section 530 "safe harbor" relief is not available to the construction industry, the IRS could attempt to recharacterize legitimate independent contractors as employees, clearly producing disruption and turmoil in the industry. And, over time, the rules promulgated by the IRS could become **subjective at the agent level,** with the end result of **inconsistent applications** throughout the country.

Several examples of subcontractor situations that could be misconstrued by IRS agents as employer-employee relationships are:

- "Punch list" clean-up where many miscellaneous corrections are required in the work.
- Contracts which include "installation only" with materials supplied separately to the subcontractor—e.g., using an HVAC subcontractor to install a central air conditioning system.
- Remodeling work where hidden site conditions are unknown and, therefore, the extent of the work is not determined in advance.

CFMA's experience indicates that repealing the section 530 industry practices "safe harbor" is the wrong approach because eliminating this provision will not affect most instances of misclassification. In fact, it would have the perverse effect of removing a safe harbor that protects firms also making good faith efforts to comply with the 20 factor test.

CFMA recognizes that the 20 common law factors determining the classification of workers are unclear and can lead to unintentional misclassification. CFMA also recognizes that there are abuses in the system, but does not believe that these abuses are so widespread that the entire working structure of the industry needs to be dismantled. **CFMA contends that the majority of construction contractors use legitimate independent contractors for legitimate economic reasons.**

The Twenty Factors Test

Section 530 was enacted 16 years ago because the rules for classifying a worker as an employee or as an independent contractor are confusing and subjective. Those rules basically require considering 20 factors developed by the IRS from court decisions which determine if a worker is controlled by an employer.

We thought it may be helpful for the Committee to see how these 20 factors—in the absence of the section 530 industry practices "safe harbor"—might be used to recharacterize a traditional contractor/subcontractor relationship as an employer-employee relationship. Not all of the 20 factors have to be met to find the employer-employee relationship, so contractors will be faced with the possibility of having to continually defend doing business with subcontractors.

Examples of how the 20 factors could be interpreted by IRS to question the existence of subcontractor relationships and to find an employer-employee relationship are as follows:

1. Instructions—The general contractor has the overall responsibility for safety and management of the jobsite and will direct subcontractors re: when they can work and the safety rules to be followed on the project.
2. Training—Certain work may be very technical or complicated, which could result in the general contractor providing training for subcontractor workers regarding materials handling, installation, safety, etc. For example, in the construction of "clean rooms" for manufacturing wafers and computer chips, it is common industry practice for the general contractor to provide "cleanliness training" for all workers—including the subcontractors' workers—to insure that the "clean rooms" meet contract requirements.
3. Integration—The general contractor will provide the schedule of access and completion times and coordinate work of other specialty contractors to minimize interference and increase productivity.
4. Service Performed Personally—A subcontractor's principal may also perform a portion of the work, especially if it is a sole proprietor or a small contractor.
5. Hiring, Supervising, and Paying Assistants—It would not be unusual to closely supervise and direct workers of a subcontractor who are in the process of correcting punch list items.
6. Continuing Relationship—A pattern of repeat business with the same general contractor could be read as a continuing employer-employee relationship.
7. Set Hours of Work—The general contractor controls access to the project and therefore sets the hours of work.
8. Full Time Required—The general contractor monitors the progress of work and can force staffing changes to keep the work on schedule.
9. Doing Work on Employer's Premises—By necessity, the work location is established and controlled by the general contractor since it must be done at the job.
10. Order or Sequence Set—The general contractor is responsible for scheduling and coordinating subcontractors and therefore sets the order of work to enable the project to be completed on time.
11. Oral or Written Reports—The general contractor requires regular reports from the subcontractors on the progress of the work in order to continually update the completion schedule and coordinate other trades.

12. Payment by Hour, Week, Month—Usually a contract is done on a lump-sum basis but can be on a per unit, hourly or cost-plus basis. Anything other than lump sum could be suspected of representing an employee situation.
13. Payment of Business and Traveling Expenses—This is usually not a factor, but if it should be, it is possible that reimbursement of these expenses would be provided for in the agreement.
14. Furnished Tools and Materials—Most subcontractors supply their own tools, but it would not be unusual for the general contractor to supply materials purchased separately from the subcontract agreement.
15. Significant Investment—Many contractors can maintain a business with little investment by working out of their homes or minimal rented space and using rented tools and machinery.
16. Realization of Profit or Loss—Independent contractors will most likely have the exposure, but may have a cost-plus contract which could isolate them from most exposure to loss.
17. Working for More than One Firm at a Time—Small contractors may not have the capacity to do this, but will have multiple contracts to be done on a rotating basis.
18. Making Service Available to the General Public—Independent contractors may be available to do work for general contractors, but not necessarily for the general public.
19. Right to Discharge—Owner contracts typically contain language that gives them the right to discharge any workers they find objectionable. The same right is given to the general contractor.
20. Right to Terminate—A subcontractor under certain contracts can terminate a relationship, providing proper notice is given.

These examples show that there could be many situations which could be falsely read as employer-employee relationships, resulting in the assessment of inappropriate penalties, interest and taxes. The construction industry today does business as it always has by subcontracting work. This is the reason that long-standing industry practice is relied on by law and the courts, not only for the construction industry, but for all industries.

DE-COUPLE HEALTH CARE AND WORKER CLASSIFICATION ISSUES

President Clinton's health care plan hits the construction industry broadside on a third front. Not only does this bill give the IRS unilateral authority to write the rules governing the classification of workers for health care, but it extends that scope to include federal income and employment taxes.

If the new rules on worker classification are allowed to apply beyond the scope of health care, they will affect tax provisions wherever a worker's status as an employee or independent contractor is relevant. Such a coupling would have a profoundly negative impact upon the construction industry.

In effect, all subcontractors and trade specialists (and their employees) could become the "employees" of general contractors. Such a radical change would:

- Threaten the long-standing and **economically viable** practice of subcontracting.
- Threaten the ordinary way of doing business for smaller contractors—especially sole proprietors.
- Force untold numbers of general contractors to file for bankruptcy because they could not assume the increased tax, health/life insurance, and retirement costs required for these new "employees."

CFMA strongly opposes using health care reform as the vehicle for addressing these complex worker classification issues, particularly if the new changes also apply to federal income and employment taxes.

CFMA PROPOSES

CFMA contends that many of the problems in classifying workers simply do not lend themselves to an easy solution and that a better approach would be to improve IRS enforcement of current law. CFMA proposes that a significant part of the compliance problem could be solved by:

- Increasing IRS compliance efforts and improving their computerized auditing systems.
- Increasing IRS efforts to match TIN returns with independent contractors' tax returns.

- Increasing penalties for those who blatantly and consistently fail to provide accurate TINs.
- Making a good faith effort to work with industry representatives to hone down the current 20 factor test to those factors that are most relevant.

CONCLUSION

Construction industry business failures are already higher than any other industry and hit record levels in 1991 and 1992. But, most importantly, the construction industry historically has played an important role in creating well-paying jobs for our economy.

Giving the IRS statutory authority to classify workers for health care and employment/income tax purposes, coupled with the loss of the long-standing industry practice "safe harbor," will disrupt the industry and eliminate many jobs for many taxpayers. It will also seriously jeopardize the ability of many contractors to remain in business.

CFMA contends that the majority of construction contractors use legitimate independent contractors for legitimate economic reasons. CFMA also recognizes that there are abuses in the system, but does not believe that these abuses are so widespread that the entire working structure of the industry needs to be dismantled.

CFMA supports all efforts to identify and penalize those who consistently abuse the independent contractor system and stands ready to work with Congress, Congressional staff, and the IRS to that end.

STATEMENT OF CRAIG WILLETT AND ASSOCIATES

Thank you for your invitation to testify before you today. My name is Craig Willett. I am a CPA from Provo, Utah and an active member of the National Federation of Independent Business (NFIB). The proposed Health Security Act has a provision to give the Treasury Department authority to determine a worker's, status. Giving the Treasury this authority will make many companies who now use independent contractors more hesitant to use independent contractors because of the potential for worker re-classification and the resulting penalties.

We have heard many theoretical arguments on the Health Security Act and the provisions affecting worker re-classification. I would like to share with this Committee some real world examples of the impact this proposed legislation will have on some of my clients.

I have two clients in particular for whom this has been a major issue this year. One is a computer software development company that uses some independent contractor programmers. The programmers use their own equipment, time, and facilities to produce certain portions of the program (although they maintain an outside client base of their own). During certain periods of operation, these people work almost exclusively for my client. For that period of time, my client could be examined for re-classification a re-determination of employee status could be made. Such re-classification would be very costly. Therefore, the company is already somewhat hesitant to use independent contractors. If the IRS were able to define a worker's classification, be forced to reconsider its use of independent contractors.

The management of this company feels that the use of employees in some of these cases is a very-poor use of their sources. In their experience, employees generally take 2–3 times longer to create programs. Productivity would decrease dramatically if they were forced to use employees rather than independent contractors. According to the company's management independent contractors contract for a specified time, specified result, and a contractual cost. This represents an efficient use of the company's resources. The free market system increases timing and productivity. These two factors of timing and productivity are most significant in determining the financial success of my client.

This company has negotiated programming contracts and is seeking additional funding based on their current cost structure. Should the Treasury be allowed the authority to completely redefine worker classification this company would be faced with seeking additional capital at a greater cost in terms of control, credibility, and rate. The cost of their product development could double due to higher costs and inefficiencies. If the company is not capable of raising the required capital they would be forced to cease operations. Most companies cannot go back to the well for two times the original capital without giving up substantial control.

Another client is a training consultant to many large companies. During the last two years, he has done a substantial amount of work for one of the nations largest high-tech companies as an .independent contractor. This company has been hesitant

to renew their contract with my client because of the substantial penalties associated with worker re-classification and the uncertainty of the definitions in the Health Security Act.

My client is legally blind and derives a substantial amount of income from his contracts. He fears that the hesitancy of this company to renew his contract will not be an isolated event. In fact, he fears that the granting of the authority for worker classification to the Treasury Department will be devastating to his business and income. Currently, my client has hired three part-time employees to help him in his business. He is faced with the decision of terminating these employees. He certainly has no plans to grow his business any further in light of the proposed changes in granting the Treasury Department the authority to redefine his status.

I feel that granting the authority to the Treasury Department will reduce productivity in our nation's economy, increase costs, and decrease profitability. The nation's largest companies have just down-sized by displacing much of their middle management. This group of former employees is a premiere candidate for starting independent contractor consulting practices. These practices are the embryo of tomorrow's employers and profitable companies. The law as it currently stands works. The 20-point common law test coupled with section 530 allows for a two way street. The proposed legislation grants too much authority to the Treasury Department and would decrease the flexibility necessary for our free market economy to function effectively. Flexibility needs to remain in the system to allow for the greatest productivity possible in our economy. It is one of the hallmarks that has made America an economic giant.

The 20 common law rules and the Internal Revenue Code Section 530 provide the flexibility necessary to allow businesses the freedom they need to function. This freedom and flexibility should not be further prohibited by giving the Treasury Department the full authority to define worker classification. As' I have illustrated using the real life examples of some of my clients (who are not alone), the Health Security Act's provision granting the Treasury Department a one-way street will result in fewer employers willing to use independent contractors and will have a devastating effect on independent contractors, themselves, and on our economy.

STATEMENT OF THE DIRECT SELLING ASSOCIATION

My name is Neil Offen. I am President of the Direct Selling Association (DSA). DSA very much appreciates the opportunity to submit this testimony to the Committee regarding the treatment of independent contractors under health reform legislation.

DSA is the national trade association of the direct selling industry. DSA represents more than five million independent contractor direct salespeople and the 150 direct selling companies with which they deal. We have on average over 10,000 direct salespeople per Congressional district.

PROFILE OF THE TYPICAL DIRECT SELLER: PART-TIME SALES ACTIVITY TO SUPPLEMENT FAMILY INCOME

Direct selling is a well-established method for marketing products to consumers directly, primarily in their homes. Companies within the industry market a broad range of consumer products and services, including household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, household decorative products such as baskets, home improvement products, food, and vitamins.

Most direct selling companies within our industry are small businesses. Over 99.5 percent of the direct salespeople that market these companies' products are independent contractors. Each of these independent contractors in effect is a micro-small business.

Direct selling offers a broad opportunity for these individual entrepreneurs. There are virtually no barriers to entry into direct selling—precisely because of their status as independent contractors. It is a field open to anyone. There are no demands that direct salespeople spend a given number of hours or adhere to any sort of work schedule. Simply stated, direct selling is an ideal way for people with an entrepreneurial spirit to earn extra money without experience, without capital, and without having to make a full-time commitment to an employer.

As the result of this ease of access and flexibility in work arrangements, direct selling has wide appeal among women who have significant family responsibilities, as well as attracting substantial numbers of minorities, the elderly, and handicapped persons. Of our more than 5 million independent contractor salespeople across the United States, 90 percent are women. Some 12.5 percent of direct sales-

people are African-Americans, 4.7 percent are Hispanics, 1 percent are Asians, and .5 percent are Native Americans or Alaskan Natives. 4.5 percent are over age 65, and 8 percent have disabilities.

The overwhelming majority of direct salespeople conduct their direct selling activities on a part-time basis. 89 percent of direct salespeople spend less than 30 hours per week at direct selling, and many do it only for a few weeks or months per year. Some 57 percent do direct selling for less than 10 hours per week. Only 6 percent do direct selling for 40 hours per week or more.

In the great bulk of cases, direct selling serves as a supplement to family income, with the main household income source coming from full-time employment of the direct seller, his or her spouse, or both. 56 percent of all direct = sellers have traditional employment in addition to their self-employment as independent contractor direct salespeople. 86 percent of direct sellers who are married have an employed spouse. For 60 percent of salespeople, direct selling activities provide less than 10 percent of household income. For 72 percent of direct salespeople, direct selling produces less than 20 percent of family income.

THE INDEPENDENT CONTRACTOR STATUS OF DIRECT SELLERS IS WELL-ESTABLISHED FOR FEDERAL TAX PURPOSES

The independent contractor status of direct sellers has long been recognized for federal tax purposes. Almost 20 years ago, direct sellers established themselves as independent contractors for tax purposes under the common law rules in the test case of *Aparacor, Inc.* v. *United States,* 556 F.2d 1004 (Ct. Cl. 1977). In 1982, Congress adopted I.R.C. §3508 to "provide a statutory scheme for assuring the status of . . . direct sellers and real estate salespersons as independent contractors." (Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (1982), 382).

Code section 3508 establishes three conditions in order for a person to qualify as a "direct seller" treated as an independent contractor by statute. First, the person must be engaged in the business either of: (a) selling consumer products to any buyer on a buy-sell basis, deposit-commission basis, or similar basis prescribed by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, or (b) selling consumer products in the home or otherwise than in a permanent retail establishment. Second, substantially all of the remuneration paid for the direct selling services must be directly related to sales or output, rather than to the number of hours worked. Third, the direct selling must be performed pursuant to a written contract between the direct salesperson and the direct selling company, and the contract must provide that the direct salesperson will not be treated as an employee of the company for federal tax purposes.

As part of this statutory classification of direct sellers as independent contractors for tax purposes, Congress also adopted a special tax information reporting system for direct salespersons. *See* I.R.C. §6041A(b). Under this special direct seller information reporting system, each direct selling company that sells $5,000 or more of consumer products to a direct salesperson on a buy-sell or deposit commission for resale must indicate so on a special direct seller box on the I.R.S. Form 1099-MISC, which is then filed with the Revenue Service and sent to the direct salesperson. This information filing requirement also applies to an "up-line" distributor in a multi-level direct selling arrangement who is re-selling to other direct salespeople down the line. In addition, the Form 1099-MISC is used to report the payment of commissions, bonuses, and awards to direct salespeople. The direct salesperson is required to provide his or her taxpayer identification number to the direct selling company as part of this process.

This statutory treatment of direct sellers as independent contractors and the special direct seller tax information reporting procedure constitute a clear and well-established system that has worked effectively for federal tax purposes for more than a decade and has achieved an extremely high rate of tax compliance for the direct selling industry.

PRESERVING INDEPENDENT CONTRACTOR STATUS FOR DIRECT SELLERS

In a meeting with DSA representatives regarding the Administration's Health Security Act, Assistant Secretary of the Treasury Samuels and a senior representative of the Commissioner of Internal Revenue confirmed that the current statutory arrangement for direct sellers under Code section 3508 is working well and has produced a good compliance record. Assistant Secretary Samuels indicated that Treasury is satisfied with the effectiveness of the current statutory arrangement for direct sellers. He further stated the present statutory classification of direct sellers as

independent contractors would be preserved under the Administration's Health Security Act.

Accordingly, the current statutory classification of direct sellers as independent contractors under Code section 3508 has been preserved under the Health Security Act, which employs the same classification rules for employment tax purposes and health care purposes. (S. 1757, sec. 7301(a)).

This statutory classification of direct sellers as independent contractors must be preserved under any health reform legislation adopted by the Committee.

IMPLEMENTATION ISSUES FOR DIRECT SELLERS UNDER THE ADMINISTRATION'S HEALTH SECURITY ACT

Under the approach of the Administration's Health Security Act, a self-employed individual is deemed to be his or her own employer and to pay wages to himself or herself equal to the amount of net earnings from self-employment. (S. 1757, sec. 6126(a)). The self-employed individual thus is responsible both for the 80 percent employer share of the health coverage premium and the 20 percent family share of the premium. Where the self-employed individual has other employment, the amount of the deemed employer premium due in respect of the self-employment is reduced by the amount of employer premiums payable in respect of such other employment. (Sec. 6126(b)).

Payment of this deemed employer premium by the self-employed person is to be made not less than quarterly under a special rule in the Administration's proposed Act. (Sec. 1345(c)(1)). However, the proposed statutory language does not explicitly state whether such deemed employer premium is payable prospectively for the subsequent quarter or retrospectively for the preceding quarter. The family share of the premium is to be withheld from wages where the family has at least one qualifying employee and otherwise is payable at least monthly on a prospective basis.

In implementing these rules as self-employed independent contractors, direct salespeople face a number of technical issues which must be addressed in any version of the health care legislation containing some form of employer mandate.

1. DE MINIMIS THRESHOLD FOR DIRECT SELLERS

The unique characteristics of the direct selling industry clearly require some form of modest *de minimis* earnings threshold for direct sales people with respect to the deemed employer premium. Such a *de minimis* threshold would serve the administrative ease of the health coverage providers and the fiscal interest of the federal government, as well as removing an administrative burden from the direct seller.

As described above, precisely because direct selling has no barriers to entry and requires no initial capital, there is a continuous flow of new recruits without substantial financial resources to invest in their new business. To impose an immediate liability on such recruit for the deemed employer premium would be an intolerable cost burden.

In addition, by its very nature, direct selling is a part-time business activity for the great bulk of the direct salespeople, undertaken to supplement the principal household income source. The majority spend less than 10 hours per week at direct selling. There is no set schedule. Sales are unpredictable, especially for the beginner. In many cases, sales activities are sporadic, undertaken to help with family bills, earn something extra for holidays, help with back-to-school clothing purchases, or to replace a worn-out home appliance.

Because of the ease of moving in and out of the business, there is a high turnover rate among direct salespeople—an annual turnover rate for the industry in excess of 100 percent. Thus, at any given moment, there may be two million direct salespeople actually selling, but during the course of the year over five million direct salespeople will have been active. Direct selling companies recruit over forty thousand (40,000) independent contractor direct salespeople every week.

Moreover, the majority of direct sellers have a traditional employment job in addition to their self-employment as an independent contractor. The great bulk of the remaining direct sellers who are without other employment are married to a spouse who is employed. Accordingly, under an employer mandate regime, the great bulk of direct sellers already would have employer premiums paid on their behalf by reason of other employment of themselves or their spouse.

It would be a very serious impediment to the recruiting that is so crucial to the health and growth of the direct selling industry if a non-working spouse already receiving health coverage funded through his or her spouse's employment were to face the cost of paying for that coverage a second time, merely because he or she is entering the direct selling business to supplement. on a part-time basis, family income. We should note that for those already earning substantial net income from direct

selling careers, we do not oppose their paying the deemed employer premium applicable to self-employed persons.

For all of these reasons, a modest *de minimis* threshold for direct salespeople based on earnings would greatly simplify the application of the Administration's proposed health care regime to direct sellers. Such a *de minimis* threshold would relieve the administrative and cost burdens of the new rules in the case of beginning recruits, very modest sales, sporadic sales activity, and direct sellers who do not stay in the business for long—keeping in mind particularly that in the great bulk of cases direct selling activity is undertaken on a part-time basis as a supplement to regular full-time employment of that person or his or her spouse. There would be no need for a subsidy—federal or otherwise—with respect to the deemed employer premium in cases where the *de minimis* earnings threshold applied.

The Administration already has embraced such a *de minimis* employment concept in the Health Security Act by excluding from the category of qualifying employee for purposes of the employer premium requirement those working less than 40 hours per month. (Sec. 1901(b)(2)(A)(ii)). We think our proposed *de minimis* threshold gives similar equitable treatment to part-time direct salespeople.

Accordingly, DSA proposes that in light of all of these unique characteristics of the direct selling industry, a *de minimis* earnings threshold of $5,000 be applied for direct sellers with respect to the deemed employer premium obligation imposed under section 6126 of the Administration's proposed Health Security Act (or similarly imposed under some other version of health reform legislation that may be considered by the Committee). Under this approach, no deemed employer premium would be collected until the direct salesperson's net earnings from self-employment as a direct seller exceeded $5,000 for the year.

If net earnings did not exceed $5,000 for the year, no deemed employer premium would be due. If net earnings from direct selling rose above $5,000 during the year, the employer premium would be calculated with respect to the full amount of the person's net earnings from direct selling, including the initial $5,000 amount. Similarly, the proposed 100 percent tax deduction for health insurance premiums of the self-employed would not be allowable with respect to any portion of the premium if net earnings from direct selling failed to exceed the $5,000 *de minimis* threshold for the year. With respect to the family share of the premium, the entire amount of earnings from direct selling would be taken into account in determining household income for purposes of the family premium, even if such earnings did not exceed the *de minimis* threshold.

2. RETROSPECTIVE PREMIUM PAYMENTS ON EARNINGS ABOVE THE DE MINIMIS THRESHOLD

As noted above, the Administration's Health Security Act does recognize the unpredictability and unevenness of the revenues earned by the self-employed in permitting the deemed employer premium to be paid on a quarterly basis. However, the Act does not clearly state whether such premium payments are to be prospective or retrospective.

DSA strongly urges that the Act—or any variation thereof utilizing this deemed employer premium concept for the self-employed—be clarified to provide that payments of the deemed employer premium by the self-employed are to be made quarterly on a retrospective basis. It is not merely a matter of having the revenues in hand by which to fund the premium payment. It is a matter of calculating the amount of the deemed employer premium in the first instance. Particularly in light of the sporadic sales activity in the direct selling industry, it could be very difficult to predict three months in advance the amount of sales and expenses and hence the amount of employer premium that would be due in accordance with the employer premium caps which look to net earnings in the case of the self-employed. This retrospective payment issue may extend beyond direct sellers to affect the self-employed more generally.

3. CREDIT FOR OTHER EMPLOYMENT

As noted above, the Administration's Health Security Act would provide a self-employed person facing the deemed employer premium with respect to his or her self-employment earnings with a credit equal to the amount of employer premium payable in respect of other employment of that person. (Sec. 6126(b)). DSA strongly endorses the need for such a credit mechanism to ensure that a person who already has employer premiums paid on his or her behalf by reason of a traditional employment job is not forced to pay for that coverage a second time merely by taking up secondary, part-time self-employment.

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DSA would like to raise an important technical issue under this credit mechanism, which should be addressed in the legislation. The Act presently provides that the amount of deemed employer premium of a self-employed individual "payable in a year" is reduced by the amount of employer premiums payable in respect of other employment "in the year." Where, as in the case of direct selling, the self-employment would be occurring concurrently with the other employment giving rise to the credit, how is the credit to be implemented?

Waiting until the end of the year to apply the credit would result in double payments and the administrative burden to the regional alliance of refunds, as well as the significant financial burden on the self-employed person. The more desirable approach would apply the credit against self-employment liability contemporaneously. That is, assuming that the suggested quarterly retrospective approach is adopted for the deemed employer premium, the amount of such premium due would be reduced by the amount of other employer premiums paid on behalf of the individual by another employer during that quarter.

CONCLUSION

If the Committee adopts an approach to the employer mandate under which a person who already receives employer-funded coverage through traditional employment of that person or his or her spouse is not subject to a second employer premium by reason of entering separate self-employment as an independent contractor, the duplicative premium payment problems outlined above for direct sellers should not arise and the proposed *de minimis* exception should be unnecessary.

If instead the Committee ultimately adopts an employer mandate regime that, like the Administration's Health Security Act, imposes a deemed employer premium obligation upon self-employed persons already receiving health coverage from traditional employment of that person or a spouse, we strongly urge the Committee to include the proposed $5000 *de minimis* earnings exception for direct sellers, as well as paying heed to the other technical suggestions outlined above.

In closing, let me reiterate DSA's strong willingness to work closely with the Committee and the Administration to develop effective and workable anti-abuse rules to address concerns regarding the employee classification issue. We have appreciated the cooperation of the Treasury Department in working with us to address our concerns under the Administration's proposals.

Thank you for the opportunity to present these views to the Committee.

STATEMENT OF ELECTROLUX CORPORATION

Mr. Chairman, my name is Steve Cooper. I am General Counsel for Electrolux which manufactures and sells vacuum cleaners, floor polishers and related accessories and supplies. Our company's headquarters are located in Marietta, Georgia, and we have manufacturing plants in Bristol, VA, Burlington, NC and Piney Flats, TN. We also have approximately 400 branch offices all over the country. We have been in business in the United States since 1924.

Electrolux markets its products through direct sales agents. During 1993, our sales force was comprised of over 45,000 independent contractors and 2,000 employees, all of whom are compensated on a commission basis.

As I believe the Direct Selling Association has testified, commission-based sales programs have unique human resources characteristics. First, throughout the industry, 57% of salespeople work less than 10 hours per week and only 6% do direct sales more than 40 hours per week. Thus, for most direct sellers commissions are rarely their primary source of income. In fact, direct sales provide less than 10% of household income for 60% of the salesforce and less than 20% of household income for 72% of the salesforce; 56% of direct sellers have separate employment and 86% of married salespeople have employed spouses. Also, direct sales has an exceptionally high turnover rate, exceeding 100% per year.

Electrolux is a member of the Direct Selling Association, and we wholeheartedly concur with their assessment of the issues affecting independent contractors in the direct sales industry.

However, because many of our sales agents are part-time employees, we have additional concerns which have not been addressed by DSA. Our direct sales employees are located throughout the country. Because they are paid on a commission basis, we have never tracked the hours worked by these individuals, nor do we have any mechanism to do so. The inability to keep track of their hours has been recognized in the Fair Labor Standards Act's ("FLSA") exemption for outside commission paid sales people from the minimum wage and overtime provisions (29 U.S.C. §213 (a)(1) and 29 C.F.R. §541.5).

Most of our sales agents use their Electrolux relationship to supplement their income; 94% of our sales agents earned $5,000 or less from Electrolux. The commission-based compensation structure has enabled us to maintain mutually beneficial relationships with our sales agents, no matter how much or how little a particular agent chooses to work.

The vast majority of our direct sales employees currently obtain health care coverage through another job or through a spouse. Given that most of these employees use their Electrolux relationship only to supplement other income, this makes sense. Electrolux makes health insurance available to those direct sales employees who earn more than $16,000 per year, on the theory that they are working for us on a full-time basis.

Certain details of the President's Health Security Act, (the "Plan") concern us deeply. Under the Plan, employers' premium payments are based, in part, on the number of employee full-time equivalents ("FTEs"). A part-time employee will be counted for this purpose if he or she works between 40 and 120 hours per month.

The problem from our perspective is that the Plan provides no explicit method for addressing part-time workers who are not employed on an hourly basis. The National Health Board is responsible for developing a method to calculate the FTE equivalency of such workers, and is instructed to take into account FLSA requirements.

Since, as stated above, direct sellers are exempt from the FLSA, it cannot provide any guidance to the National Health Board in promulgating rules for determining coverage for part time direct sales people. Without Congressional guidance, the National Health Board would have complete discretion over the treatment of direct sales employees. Depending on how the Board chose to wield its power, Electrolux could ultimately find itself with enormous premium liabilities for its less productive sales agents. We could be placed in the position of having to dismiss a great number of our sales agents since it would be impossible to cover them without dire financial consequences. Other employers may find themselves in similar circumstances as well.

Accordingly, Congress needs to provide the Board with greater direction on the treatment of direct sales employees. To simplify matters administratively, there should be a "de minimis" threshold below which the employer of a part-time direct sales worker would not be responsible for premium payments.

We estimate that a direct sales worker with an established customer base earns approximately $10 per hour. If such an employee worked 40 hours per month throughout the year, he or she would earn approximately $5,000. ($10 per hour x 40 hours per month x 12 months per year = $4,800.) Hence, a $5,000 per year earnings threshold for a commissioned sales employee would approximate the 40 hours per month threshold already contained in the Plan.

We recognize the importance of achieving universal health care coverage. However, a $5,000 threshold for direct sales employees would not compromise this goal. As stated above, our low earning sales employees use the position primarily to supplement other income. Thus, almost all of our sales employees earning less than $5,000 would obtain health coverage either through their principal employment or through their spouses. Those very few employees who earn less then $5,000 per year and have no other income would be eligible for governmental subsidies.

The $5,000 threshold would also be easier to administer. Rather than having employers and the National Health Board bicker over the appropriate 40 hours per month equivalent, Congress would have already established a "bright line" test. This should simplify programs operations for this particular population.

We believe this issue has arisen solely because of oversight rather than a conscious policy decision. We stand ready to work with this Committee or any other to address the problem.

STATEMENT OF HARRY L. THOMAS, INC.

I own and operate a floor-covering business called Harry L. Thomas, Inc. It is a small business which employs 18 people, and its been in existence for 42 years. My employees receive retirement benefits and medical-insurance coverage. I took over the company from my father, Harry Thomas, and I hope to pass it on to my children.

Though I am not speaking for them in this testimony, I am a member of the Coalition for Fair Employee Classification. The CFEC is dedicated to just enforcement of the law and the adoption of fair standards that everyone can live by—employers and employees.

Fair standards is what is being threatened today in the construction industry. Everyday, I must compete against other employers who misclassify their workers as independent subcontractors. They misclassify their employees in order to avoid paying social-security taxes, unemployment taxes, medicare taxes and workers' compensation insurance premiums. Currently, the Internal Revenue Service has not been able to adequately enforce the law. My lack of competitiveness because I abide by the law is even greater because I provide my employees with medical insurance.

I was excited by the Clinton plan's mandate on employers to carry health insurance. This would, to a degree, level the playing field, but it will not work, unless the law is adequately enforced.

Misclassification in the construction industry, according to the IRS, occurs frequently. *(Internal Revenue Service: Efforts in Addressing Misclassification of Employees as Independent Contractors in the Construction Industry,* March, 1994, pp. 2, 3, and 6 (hereinafter "IRS Study.") Indeed, the industry is the most non-compliant. (IRS Study at 2.) Even Governor Weicker's Bridgeport, Connecticut office was built by a contractor which misclassified its employees. ("Drywall Contractor Cited for Dodging Payroll Taxes," *New Haven Register,* Sunday, June 20, 1993, p. F3.)

According to a study done by the University of Connecticut Department of Economics, misclassification in Connecticut alone cost the state and federal governments, conservatively, 501 million dollars in 1992 alone. *(Executive Summary: Costs to Connecticut of Employee Misclassification 1992,* by William T. Alpert, P. 7 (hereinafter "UConn Study"). The breakdown of losses is as follows:

$267 Million, Federal Income tax
$95 Million, Social Security Tax
$65 Million, State Income Tax
$57 Million, Workers' Compensation
$17 Million, Unemployment Insurance.
(UConn Study at 7.)

The IRS consistently cites the safe harbors in section 530 as a reason why they cannot adequately enforce existing law. I agree with them that section 530 need significant changes. I suggest eliminating the prior audit rule where there hasn't been an IRS employee-classification audit. In addition, eliminate the safe harbor for long-standing industry practices. Considering the growing abuse in construction, breaking the law could eventually become an industry practice, because the IRS has not been able to stop the violators from driving law-abiding employers out of business. The IRS should adopt rules which give leniency to employers who voluntarily reclassify workers from independent contractors to employees. Finally, the IRS should be allowed to issue guidance to employers regarding worker classification issues.

Also, many employers complain that the twenty factor test in determining employee status is too subjective. In my industry, there is usually no problem determining who the employees and independent contractors are, but I do recognize that this may be a problem in other industries. I suggest developing a test which focuses on control of the worker and whether the worker can realize a profit or loss from the transaction.

Whatever test is developed, either by Congress or the IRS, it should continue the policy of existing law favoring employee status. Otherwise, the valuable safety nets of unemployment, social security and workers compensation will be lost. These safety nets keep a lot for families form falling into poverty. Also, if employee status is not favored, there will not be enough revenue for the government in general and, specifically, a national health-care plan. Numerous studies have shown that independent contractors are less compliant. If the number of independent contractors grows, people, like me, who play by the rules and pay the nation's bills for the good of the nation, will cease to be.

In summary, employer mandates for health insurance are positive, but if it is going to work, section 530 must be amended and the law must be enforce. Currently, existing laws are not being adequately enforced, and a growing number of workers and employers face reduced standards of living as illegal black-market competitors take charge of the industry.

Attachments.

Executive Summary—Costs to Connecticut of Employee Misclassification, 1992

[Prepared for the Carpentry Industry Partnership, Norwalk, Connecticut]

THERE ARE MANY INCENTIVES TO "MISCLASSIFY"

Businesses must classify workers either as "employees" or "independent contractors." There are serious pecuniary consequences whenever a firm makes this classification. Enterprises which choose to classify their workers as independent contractors rather than employees are:

—not responsible for state or federal income tax withholding;
—not required to pay payroll taxes for unemployment insurance, social security and medicare;
—not likely to carry workers' compensation insurance for their workforces;
—typically not providing their workers with traditional fringe benefits such as health insurance, pensions, sick leave, vacations and other forms of non-cash wage supplements;
—not required to comply with provisions of the Fair Labor Standards Acts (FLSA)— minimum wage, maximum hours, etc.;

For a typical firm, then, the incentives to misclassify employees as independent contractors are substantial: reduction of the paperwork cost of income tax withholding; elimination of payroll tax costs amounting to almost 20 percent of payroll for a typical firm in Connecticut; removal of workers' compensation costs, which are astronomical in some hazardous occupations amounting to as much as forty to fifty percent of payroll; and finally, eradication of private fringe benefit costs, which now approach 20 percent of payroll for the representative firm, but are much higher in many businesses. In addition, the potentially high costs of complying with the FLSA are incentives to misclassify workers.

Thus when a business misclassifies its workforce its "savings" may approach 30 to 40 percent of its payroll. This obviously provides it with an enormous advantage in the conduct of everyday business, for example when bidding on contracts. The result is that businesses that play by the rules loose—cheaters win!

As for the workers, they too have strong incentives to engage in misclassification schemes. First, unemployed people may be faced with a grim choice between accepting independent contractor status or remaining jobless. Second, independent contractors are not subject to income and payroll tax withholding. It is estimated by the Internal Revenue Service (IRS) that workers not subject to withholding voluntarily report for tax purposes only between 62 and 76 percent of their incomes while employees subject to withholding report virtually 100 (99.5) percent of their incomes. Third, employees classified as independent contractors are entitled to claim as deductions form their income taxes certain work-related expenses which may not be deducted by workers classified as employees. Finally, younger workers in particular tend to see little value in social security, workers' compensation, private pension plans or health insurance and prefer to take a portion of the value of these benefits in the form of current cash payments. Thus, harsh economic realities and economic incentives are compelling reasons for employers and workers alike to flout the laws on worker classification.

Furthermore, misclassification affects not only workers and businesses directly but also has other ramifications. Obviously, misclassification directly lowers government revenues. Moreover, workers who have not contributed to the unemployment insurance system will not collect benefits if they become unemployed. Depending on their other unemployment income and their savings, unemployed former "independent contractors" maybe forced onto the state's public assistance rolls imposing a still greater burden on taxpayers. Those who are not reporting income are probably not participating in the workers' compensation system. Should they be injured on the job, they will be required to obtain their settlement form the "Second Injury Fund" which is financed, in part, by a special assessment on state employers. This fund has experienced a remarkably rapid rate of increase during the last decade, partially due, to worker misclassification. Whenever an injured worker does not received a settlement from the workers' compensation system, support for the afflicted employee may by necessity require that other public relief funds be tapped to maintain the disable worker. Finally, when improperly classified workers fall ill, their health care expenditures will often be added to the state's increasing burden of uncompensated care costs.

NATIONAL MISCLASSIFICATION COSTS ARE SUBSTANTIAL

The IRS and General Accounting Office (GAO) have made various attempts to estimate the tax losses from misclassification of employees. In 1989 IRS published a report that "Conservatively: estimated about $15 billion was paid in 1984 to individuals who should not have been classified as independent contractors. IRS estimates that in 1984 misclassifications resulted din the loss of $1.559 billion in tax revenues. The $1.559 billion tax loss includes $899 million in lost income tax revenues, $538 million in lost social security tax revenues and $122 million in lost federal unemployment insurance tax receipts.

Translating these amounts into 1992 dollars unadjusted for tax rate changes, we find that income tax losses amount to over $1.2 billion, social security tax losses amount to $727 million and unemployment tax receipt losses come to about $165 million (both clearly understated because of payroll tax ceiling and rate increases)—a total of about $2.1 billion in 1992 dollars.

A summary of the federal studies of misclassification tax costs is presented in Table 1.

WORKER MISCLASSIFICATION COSTS IN CONNECTICUT—½ BILLION DOLLARS ANNUALLY

Our work estimates the lost state and federal income and payroll tax (social security, unemployment insurance and medicare) revenues and workers' compensation forfeitures for Connecticut caused by failures to properly classify independent contractors.

The data used here was collected from businesses in Illinois for an unemployment insurance survey. These data show that about 2.8 percent of all in-sate workers are involved with misclassification and 5.8 percent of in-state workers are involved either in misclassification or in the employer's failure to report casual or part-time labor. Our estimates of losses are likely to be conservative.

As the chart illustrates the estimates losses to Connecticut in 1992 amounted to approximately $501 million. This estimate may be as low as $118 million annually but might be as high as $756 million per year or higher (See Table 2). Given the downward bias in most of the calculations our estimates are likely on the low side.

As shown in the Chart the estimated loss of $501 million in 1992 were divided as follows:

- State Income Tax—$65 million
- Workers' Compensation—$57 million
- Unemployment Insurance—$17 million
- Federal Income Tax—$267 million
- Social Security Tax—$95 million

1992 LOSSES TOTAL—$501 MILLION

Assuming that the $501 million estimate is accurate and assuming a discount rate of 5 percent, losses continuing at this rate have a present value of over $10 billion dollars. That is, if a revenue flow equalling $501 million per year were to continue forever into the future, someone should be willing to pay over $10 billion today for the right to receive it. As a means seeing the relative size of these numbers the Connecticut state income tax garners only between $2 and $3 billion annually. These losses are substantial.

As is evident from Table 2, even "low-end" estimates of revenue losses are considerable. If, for example, the state and federal governments continue to lose as little as $118 million per year through misclassification of employees as independent contractors, and if the discount rate is 5 percent, we calculate the present value of the income stream to be about $2.4 billion dollars—which is approximately one year's worth of state income tax revenues.

The reader of our work should bear in mind several factors as he or she reviews our findings: first most of the data used for our 1992 calculations are estimated. For this and the reasons discussed in the text the calculations presented here are "ball park" estimates. One might find large differentials between our results and other estimates and as is evident even between our "low end" and "high end" figures. The important point is that misclassification—either deliberate or inadvertent—has considerable economic consequences to the citizens of Connecticut.

Furthermore, most of the numerical estimates are based on a small but representative sample of firms from Illinois. This sample was drawn in 1987 to study the Illinois unemployment insurance system and only incidently can be used to analyze the cost of worker misclassification. This obviously implies that one must accept the assumption that Connecticut is similar to Illinois in the behavior and structure of its

businesses. According to one of the project directors of the Illinois study, since Illinois is located in the midwest its businesses and workers are likely to be more compliant (less subject to misclassification) than are businesses and workers from other regions of the United States. Thus, the use of the Illinois data as representative of Connecticut most likely understates the losses to generated by misclassification in Connecticut.

The estimates contained in the report are in general very conservative for a number of other reasons. First, as noted above, during the seven years that have elapsed since the data were collected the problem of misclassification has almost certainly grown more severe. Second, the data cover only in-state businesses. It is likely that out-of-state businesses doing business in the state are substantially less compliant than in-state businesses. Third, the estimates presented here do not include those firms committing errors in wage or benefit computation or reporting nor those firms which have failed to file reports. Some of theses behaviors may relate to misclassification. Next, the computations of "loss" fail to consider the fact that if an individual has not been covered by a particular social insurance program and the loss for which the insurance program exists occurs he or she must be cared for through other social insurance plans. These alternative forms of coverage have costs. For example, suppose that a person opts out of the unemployment insurance system and he or she looses their job it may well fall to other publicly supported social service programs to maintain that individual and their family. Finally, and perhaps most importantly, the data do not take into account those workers who are not officially included on payrolls at all—those participating in the so-called underground economy or black market. The size guesses (and that term is used advisedly) for the underground economy in the United States range from 3 percent to 33 percent of the legitimate economy. Thus, it is possible that the estimates presented here might be increased by a large factor—perhaps up to six or seven times.

It should be noted that our estimates to some degree mix apples and oranges and, while for the purposes of presentation, the estimated losses have been added together, they are not strictly comparable. That is to say, the losses on the state income tax differ from the losses to the workers' compensation system, which in turn are different from the losses under the payroll tax for social security which also differ from the losses to the unemployment insurance system and the federal income tax.

To summarize, the losses that result from misclassifying employees as independent contractors are large. They appear to be growing in part because of increasing tax rates and in part because of the extremely competitive business climate.

LEVEL THE PLAYING FIELD AND LOWER THE LOSSES

Our findings indicate that polices to level the playing field should be established. We must apply the law fairly to all workers. Given that we, as a society, have agreed that specific strands of webbing are required in our social safety net then we all should have access to the entire net—not just certain filaments.

Disparate application of the law results in reinforcing lawless behavior on the part of both businesses and labor. Perhaps even more damaging has been the seemingly capricious application of differential standards favoring some types of business over others. This distorts economic activity and, defacto, favors businesses operating illegally over businesses that choose to obey the law. Such uneven legal conduct provides the wrong social and business incentives to all enterprise owners, operators and employees.

What is needed is that both state and federal governments must vigorously, uniformly and across-the-board enforce the rules that apply to employees versus independent contractors. Businesses which misclassify employees or fail to report casual or part-time labor must not be permitted to gain an illegal competitive advantage over businesses that do operate within the law.

It would also be advisable to reexamine the law with a view to clarifying it and making it less subject to differing interpretations. The GAO and various congressional bodies have previously made similar recommendations.

What is clear beyond question is that the costs to Connecticut taxpayers and workers of avoiding the problem of misclassification are unacceptably high now and are likely to grow even higher. We hope that this report will spur a serious examination of all the issues related to classification. Only through such an examination can we reach a rational decision as to what additional state resources should be applied to enforce the payment of revenues now lost because of misclassification and the failure to report casual or part-time workers.

Table 1

Selected Federal Revenue Loss Estimates from The Misclassification of Employees

Year	Agency	Size of Loss ($ billions)	Source of Loss
1984	IRS	1.6	Misclassified employees
1987	IRS	16.0	Sole proprietorships
1987	IRS	0.050	Audit of 1,120 employers with assets under $3 million each[a]
1986/7	GAO/IRS	0.017	Audits of 92 out of 95 employers paying in excess of $10,000 per year to "independent contractors" whose entire income came from one employer[b]
1987	IRS	0.468	6,900 ETEP audits[c]
1992	IRS	20.3	Self-employed

a. Resulted in reclassifying 46,258 "independent contractors" as employees.

b. The 92 employers turned out to have misclassified 17,347 workers.

c. Resulted in reclassifying 338,000 independent contractors as employees. Since fiscal year 1989, 90 percent of ETEP audits have continued to find misclassified workers.

Sources: See text footnotes

Table 2

Summary of Findings

Most Reasonable Estimates of Losses to Connecticut Through Misclassification of Employees as Independent Contractors and Through Failure to Report Casual of Part-Time Workers

(annual losses in millions of dollars)

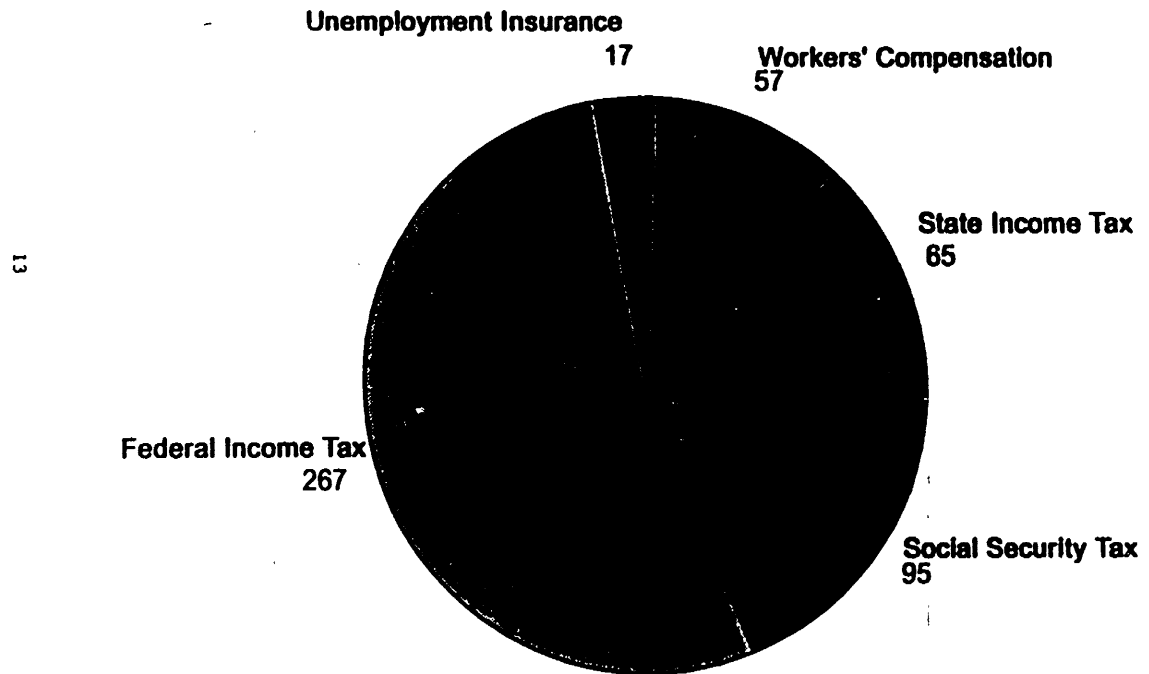
	Independant Contractor Errors Only		Independant Contractor Errors plus Non-reporting of Casual or Part-Time Workers		Best Estimate of Both Costs
	Low	High	Low	High	
STATE TAX LOSSES					
State Income Tax	$ 16	$ 48	$ 32	$ 98	$ 65
Unemployment Insurance[a]	$ 8		$17		$ 17
Workers' Compensation	$ 25	$ 30	$ 52	$ 62	$ 57
SUB-TOTAL STATE LOSSES	$ 49	$ 86	$101	$177	$139
FEDERAL LOSSES					
Federal Income Tax	$ 34	$204	$267	$462	$267
Social Security Tax	$ 35	$ 56	$ 73	$117	$ 95
GRAND TOTAL -- STATE AND FEDERAL LOSSES FOR CONNECTICUT	$118	$346	$441	$756	$501

a No high and low estimates were computed for unemployment insurance.

CHART

Estimated Losses in Connecticut Due to Misclassifications of Independent Contractors and Failure to Report Casual or Part-Time Labor

(In Millions of Dollars)



GRAND TOTAL FOR 1992 -- $501

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STATEMENT OF THE HOME HEALTH SERVICES AND STAFFING ASSOCIATION

Mr. Chairman and members of the Committee, I am James C. Pyles representing the Home Health Services and Staffing Association (HHSSA). On behalf of HHSSA, I would like to offer the following comments on the issue of worker classification under health reform.

HHSSA's members provide supplemental medical staff, such as nurses and nurse's aides, to hospitals and other health care facilities on a part time and temporary basis. The Association's members are both large and small businesses, but they have one thing in common—they all treat their supplemental staffing workers as employees in accordance with the IRS' consistent interpretation and application of the employment tax laws to our industry.[1]

Our Association is also a member of the Coalition for Fair Worker Classification, which includes associations representing hundreds of thousands of employers and workers and is dedicated to eliminating the fraud, waste, and abuse that results from the intentional misclassification of employees as independent contractors. In furtherance of that objective, our Association and the Coalition for Fair Contracting support the "Employment Status Provisions" of the Health Security Act.

The issue of intentional worker misclassification has been the subject of at least five congressional hearings in recent years.[2] The following conclusions have been conclusively established in the course of those hearings:

1. Intentional misclassification of employees as independent contractors is a pervasive and growing practice.[3]
2. Misclassification of workers deprives federal and state governments of billions of dollars annually in lawfully due revenues.[4]
3. Misclassification deprives workers of the benefits and protections of a broad range of laws, usually without their knowledge or against their will (e.g., unemployment compensation, workers compensation, disability insurance, Social Security and Medicare quarters of coverage, the Fair Labor Standards Act, the Occupational Safety and Health Act, the Americans with Disabilities Act, the Family Medical Leave Act, and employment discrimination laws administered through the Equal Employment Opportunity Commission).[5]
4. Misclassification of workers coupled with abuse of the §530 "safe harbors" results in inequitable application of the employment tax laws which places law abiding companies "at a great competitive disadvantage."[6]
5. Companies that misclassify shift their share of the cost of programs such as unemployment compensation and workers compensation to law abiding employers.[7]

The misclassification of workers in the medical staffing industry is particularly pernicious because it jeopardizes the quality of health care being provided. Competitors of our members provide nurses for the intensive care and other critical care departments of hospitals while representing that they are independent contractors over whom there is no right of control or supervision. However, supervision and integration of the services provided by nurses in such institutional settings is legally and practically imperative.[8]

Misclassification in the medical staffing industry is especially disturbing because those who misclassify are well aware that their actions are contrary to the IRS' con-

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[1] Technical Advice Memorandum 9135001 (February 28, 1991); Technical Advice Memorandum 8913002 (December 8, 1989); Private Letter Ruling 9122020 (June 4, 1991); Revenue Ruling 75-101, 1975-1 C.B. 318.

[2] "The Pros and Cons of Home-based Clerical Work," Subcommittee on Employment and Housing (1986); "Rising Use of Part-time and Temporary Workers: Who Benefits and Who Loses?," Subcommittee on Employment and Housing (1988); "Exploiting Workers By Misclassifying Them as Independent Contractors" Subcommittee on Employment and Housing (1991); "Repeal of Section 530 of the Revenue Act of 1978," Subcommittee on Select Revenue Measures (September 21, 1993).

[3] "Contractor Games: Misclassifying Employees as Independent Contractors," Committee on Government Operations, H. Rep. 102-1053, 102d Cong., 2d Sess. 10 (October 16, 1992)(hereinafter "Contractor Games").

[4] "Tax Administration: Approaches for Improving Independent Contractor Compliance," GAO/GGD-92-108, 23-24 (July 23, 1992)(hereinafter "Tax Administration"); "Contractor Games," 5-6.

[5] "Contractor Games," 2-4.

[6] "Contractor Games," 2-3, 8; "Tax Administration," 6-7.

[7] "Contractor Games," 8.

[8] *Accreditation Standards for Hospitals*, Joint Commission on Accreditation of Healthcare Organizations, §§NC.2-NC.5.6, SE.4, SP.1-S.5.4 (1993); 42 C.F.R. §482.23.

sistent interpretation of the law.[9] Further, the companies that misclassify provide precisely the same service to exactly the same hospitals and even use some of the same workers. These companies take advantage of the fact that staffing companies which treat their health care workers as employees are required to incur certain overhead costs for those workers, such as furnishing them with the three shot hepatitis B vaccination series and providing them with infection control education and training as required under the OSHA bloodborne pathogens regulations.[10] Companies that misclassify either obtain a "free ride" by shifting these costs to law abiding companies or they expose their workers to infection from diseases such as AIDS and hepatitis without training or vaccinations.

We support the Employment Status Provisions of the Health Security Act because they do two things which are essential to curbing the misclassification of workers. First, they authorize the Treasury Department to adopt regulations clarifying the definition of employee, after providing a full opportunity for public input. Second, they narrow or eliminate the §530 safe harbors once the clarifying regulations have become effective.

Only those seeking to take unfair advantage of the ambiguities in the current law could be opposed to the approach contained in the Health Security Act. The arguments against clarifying the employment tax laws generally fall into one of the following categories:

1. *Allegation:* The proposed legislative amendment will reduce or eliminate the availability of the independent contractor status.

Response: That concern is clearly misplaced because the legislative proposal merely directs Treasury to issue clarifying regulations which must "give significant weight to the common law applicable in determining the employer-employee relationship." §7301(b)(1). Further, the regulations cannot change the status of certain workers, such as direct sellers and real estate agents, who historically have not been viewed as employees. §7301(b)(2).

2. *Allegation:* The amendment will allow the IRS to adopt harsh and arbitrary rules.

Response: That allegation is simply untrue because the IRS will have to issue regulations in accordance with the rule making requirements of the Administrative Procedure Act which require notice of the proposed rules, an opportunity for public comment, a response to comments in a "basis and purpose statement" by the IRS, and an opportunity to have the rules set aside by a federal court if they are arbitrary or capricious. Further, the legislation provides an opportunity for congressional intervention by requiring the IRS to submit a report to Congress describing the purpose of the regulations and to provide a 6-month delayed effective date once the regulations are issued. §7301(e) and (d). In addition, the IRS and the public will have the benefit of guidance from the amendment's legislative history.

3. *Allegation:* No amendment is necessary because the consistency principle in the current language of §530 prevents companies from "gaming" the system by redesignating workers as independent contractors.

Response: The consistency principle provides little restraint on redesignation of workers as independent contractors because it can be easily circumvented by existing companies if they simply establish a new corporation and transfer the workers to that corporation. Of course, the consistency principle has no impact on how a new company classifies its workers.

4. *Allegation:* The misclassification of workers is too complicated and controversial to be addressed in health reform legislation.

Response: Curbing the growing abuse of the employment tax laws is long overdue and necessary as a general matter. Addressing that abuse becomes indispensable if a reformed health care system includes an employer mandate or otherwise relies on the employer-employee relationship to provide health insurance. Under the Health Security Act, for example, employers that misclassify could evade the responsibility of providing health care coverage to their workers and thereby increase the subsidies that would be required for individuals and businesses with fewer employees.

Simply by allowing Treasury to clarify the employment tax laws Congress can generate billions of dollars each year for health care reform or deficit reduction without adding any new tax or cutting a single service. Congress simply cannot expect law abiding companies to continue to shoulder increasing financial responsibil-

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[9] See testimony of Independent Nurse Brokers Association admitting that their members openly defy the IRS' interpretation of the employment tax laws. Hearing before Select Revenue Measures Subcommittee, Trans. at 165–66 (September 21, 1993).

[10] 29 C.F.R. Part 1910.

ities while competitors providing similar services are allowed to evade those responsibilities.

The Employment Status Provisions in the Health Security Act describe a process for addressing the disgraceful abuse of the employment tax laws by combining the expertise of the IRS with input from the public. We believe those provisions represent a rational approach which should be adopted *regardless* of whether Congress enacts health care reform.

STATEMENT OF THE INDEPENDENT CONTRACTOR ASSOCIATION OF AMERICA, INC.

The Independent Contractor Association of America, Inc. (the "ICAA") is a national association dedicated to the preservation of independent contractor status. A major impetus for the formation of the ICAA was the proposed changes to the rules for determining who is, and who is not, an independent contractor, contained in the Administration's Health Security Act proposal (the "HSA"). ICAA members consist of individuals working as independent contractors and businesses that purchase services from independent contractors.

The ICAA opposes the provisions contained in the HSA that would modify the rules for determining an individual's status for purposes of health care coverage and for federal income tax and employment tax purposes, because such provisions:

- would provide no enforceable assurance that long-standing legitimate independent contractor relationships would retain their independent contractor Status under the HSA;
- would unnecessarily repeal section 530 of the Revenue Act of 1978; and
- would introduce confusion and uncertainty into the market for freelance talent.

I. THE ABSENCE OF ANY ENFORCEABLE ASSURANCE THAT EXISTING LEGITIMATE INDEPENDENT CONTRACTOR ARRANGEMENTS WOULD SURVIVE THE HSA

The ICAA respectfully submits that the Treasury Department harbors too strong an institutional bias against independent contractor status to be given discretion to devise a new definition of "employee." The bias was explicitly recognized by the Congress when it enacted section 530 of the Revenue Act of 1978. Section 530(d) specifically prohibits the Treasury Department (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling "clarifying the employment status of individuals." It is submitted that the Internal Revenue Service's institutional bias has not waned over the years, but, if anything, has recently become more pronounced. A recent example of such bias is represented by the proposed coordinated issue paper concerning the classification of individuals who work in the securities industry, discussed in the Statement of Patricia A. Bellows, Representing H.D. Vest Financial Services and the ICAA, Submitted in connection with this hearing. Hence, to permit the Treasury Department to redefine employee" status is tantamount to providing for the ultimate elimination of independent contractor status.

Treasury Assistant Secretary for Tax Policy, Leslie Samuels, while testifying with respect to the HSA before the House Ways and Means Committee on February 8,1994, stated that the Treasury Department would not radically change the test under current law for determining a worker's status. However, when asked repeatedly whether he could provide any assurance to that effect, Mr. Samuels stated only that:

a. the HSA would retain the statutory independent contractor status provided direct sellers and Realtors under Internal Revenue Code section 3508;

b. the HSA would require the Treasury Department to "give significant weight to the common law applicable in determining the employer-employee relationship;"

c. the Treasury Department would anticipate the Congress providing extensive guidance in the form of legislative history, which the Treasury would assiduously follow; and

d. the Treasury Regulations containing the new rules would be prospective, and effective only for periods beginning no earlier than 6 months after the date such regulations are promulgated as final regulations.

It is submitted that the assurances provided by the Assistant Secretary are woefully inadequate to the individuals and businesses that are economically dependent on the continued viability of independent contractor status. Each of the Assistant Secretary's points is analyzed below.

A. The HSA would retain the statutory independent contractor status provided direct sellers and Realtors under Internal Revenue Code section 3508.

While direct sellers and Realtors are no doubt elated with the HSA's retention of section 3508, those provisions are of absolutely no help to any other industry. We believe, moreover, that even the direct sellers and Realtors would prefer that the worker classification changes proposed by the HSA be eliminated. As the only two vestiges of a status otherwise repealed, such groups would have cause to wonder whether the HSA is more than an ephemeral reprieve.

B. The HSA would require the Treasury Department to "give significant weight to the common law applicable in determining the employer-employee relationship."

Under the HSA, the Treasury Department will devise a new definition of "employee." If taxpayers were to challenge the Treasury Department's definition as overly broad, it is difficult to predict how a court would interpret the statutory mandate that "significant weight" be given to the common law test. It seems clear that "significant weight" could be given to the common law without the common law being adopted. Thus, one critical issue raised by such a requirement involves the extent to which the Treasury Department definition of "employee" could deviate from the common law test without running afoul of its statutory mandate.

From a pragmatic standpoint, the ICAA believes that taxpayers would face a near insuperable burden in successfully challenging any Treasury Department definition of "employee" that reflected some lineage to the common law. Requiring only that "significant weight" be given to the common law test provides no quantifiable protection to taxpayers, and leaves independent contractor status far too vulnerable. The ICAA submits that such a requirement provides inadequate assurance that the Treasury Department would not define employee in such a way as to include within its purview many long-standing, legitimate independent contractor arrangements.

C. The Treasury Department would anticipate the Congress providing extensive guidance in the form of legislative history, which the Treasury would assiduously follow.

The United States Supreme Court has cast substantial doubt on the reliability of legislative history in molding the interpretation of a statute. *E.g., Blanchard* v. *Bergeron 109 S. Ct. 939, 947 (1988).* Nevertheless, assuming even that the legislative history would be given deference by a court in interpreting the HSA, the legislative history cannot be evaluated until it is written. Since the HSA provisions concerning employee status are being offered as a package of statutory provisions and legislative history, the package cannot be evaluated on its merits until both components are presented.

The ICAA submits that a mere promise of favorable legislative history is devoid of any enforceable assurance that legitimate independent contractor relationships would be tolerated under the HSA.

D. The Treasury Regulations containing the new rules would be prospective, and effective only for periods beginning no earlier than 6 months after the date such regulations are promulgated as final regulations.

The effective date of the new definition of employee is irrelevant to the issue of what the new definition would provide.

II. UNNECESSARY REPEAL OF SECTION 530

Section 530 of the Revenue Act of 1978 is without question the strongest weapon available to taxpayers for defending against overly aggressive IRS challenges to their treatment of workers as independent contractors. While a dispute based solely on differing interpretations of the common law test can be lengthy and inordinately expensive to the taxpayer, in cases where relief under section 530 is available, the dispute can generally be resolved expeditiously.

Many taxpayers could not afford to finance a protracted dispute over the common law test. For such taxpayers, section 530 provides their sole source of protection against an IRS challenge. The HSA would repeal section 530 and replace it with a new safe harbor provision that would be more difficult to satisfy and provide less protection. Many businesses now protected under section 530 would not be eligible for the new safe harbor provision proposed in the HSA.

The new safe harbor, unlike section 530, would provide no protection for future years. In other words, the new safe harbor provision would protect an eligible business that is audited by the IRS against assessments with respect to prior years, but it would *not* protect the business from being required to reclassify the affected workers to employee status for future years. Consequently, the new safe harbor provision would accommodate a gradual conversion of independent contractors to employee

status, albeit without the service-recipient businesses incurring prodigious assessments in the process.

As explained in the paragraphs that follow, there is no justification for the proposed changes relating to section 530.

The *Joint Committee on Taxation. Description and Analysis of the Employer Mandate and Related Provisions of H.R. 3600* ("Health Security Act") (JCS-1-94) 102, February 2, 1994 ("Joint Committee Report"), states that the HSA would modify the rules for determining a worker's status **in order to prevent businesses from converting existing employees to independent contractor status.**

One of the significant changes the HSA would make to the worker classification rules is that it would repeal section 530. What makes this change remarkable is that section 530 provides absolutely no protection with respect to any worker who has been "treated . . . as an employee for any period." *Section 530(a)(1)(A).* Specifically, section 530 protection is *denied* with respect to the:

> treatment of any individual for employment tax purposes . . . if the taxpayer (or predecessor) has treated *any individual holding a substantially similar position* as an employee for purposes of employment taxes for any period beginning after December 31, 1977.

Section 530(a)(3) (Emphasis added). Inasmuch as the worker classification rule changes contained in the HSA are intended to prevent a business from converting existing employees to independent contractor status, the proposed repeal of section 530 is mystifying. As just demonstrated, section 530 already denies protection in such cases. It follows, therefore, that the HSA would repeal section 530 in order to accomplish some unstated objective, foreign to health care reform.

Because of the dramatic impact the proposed changes relating to section 530 would have on businesses that depend on independent contractors, and the utter absence of any discernible justification for such proposed changes, the ICAA urges that section 530 be left alone.

III. HIGH ANXIETY FOR THE SELF-EMPLOYED

The proposed changes to the worker classification rules would discourage businesses from entering into arrangements with independent contractors. By permitting the Treasury Department to modify the rules for distinguishing employees from independent contractors, the HSA would impose a looming uncertainty over all independent contractor arrangements.

Businesses would not know when the rules would be changed, and they would not know what the new rules would provide. Businesses would likely react by reducing their reliance on independent contractors. It is submitted that such a consequence would be damaging to the nation's economy, in addition to being demoralizing to the droves of individuals who have been victims of large corporate "downsizings" and have vowed to remain independent in order to increase control over their economic destiny.

The ICAA submits that the independent contractor sector of the economy should be nurtured, not bludgeoned. Because of the adverse impact the worker classification changes contained in the HSA would have on an individual's right to work as an independent contractor and on a business's right to engage an independent contractor, and the absence of compelling reasons for such changes, the ICAA opposes such provisions.

STATEMENT OF THE INTERNATIONAL TAXICAB AND LIVERY ASSOCIATION

Mr. Chairman: The 825 U.S. members of the International Taxicab and Livery Association thank you for the opportunity to submit this statement about the potential adverse effect of the worker reclassification proposals included in the Clinton Administration's health care reform proposal, S. 1757.

EFFECT OF WORKER CLASSIFICATION PROPOSAL

Section 7301 of the Health Security Act would permit the IRS to overturn 45 years of precedential case law and rulings, thus throwing millions of small businesses into uncertainty over whether they can rely on these rulings and disrupting their established relationships with independent contractors.

ITLA POSITION

If the Administration's Health Security Act is to be approved, we strongly urge the Finance Committee to remove all of Subtitle C of Title VII.

CURRENT LAW—THE COMMON LAW RULE

Since 1947, when the U.S. Supreme Court decided the *Silk* case, the well-established law, codified in the IRS regulations, has been that a worker is an employee for income and employment tax purposes if he is a "common law" employee—that is, if the business for which the worker performs services has the right to control not only the results to be accomplished by the worker, but also the means and methods by which the worker accomplishes those results.

The common law rule, which necessarily depends on examining all the material facts and circumstances of a worker's relationship with the business, has frequently been criticized because it is not a "bright-line" test. However, because the same rule must necessarily apply to all kinds of businesses, the common law rule's flexibility is also its greatest strength.

Moreover, during the 45 years since Silk was decided, the IRS has developed and published a list of 20 factors that it evaluates in determining whether a worker is an employee or an independent contractor. Although the IRS and many taxpayers disagree over the proper classification of workers, in most cases, the proper result has been reached.

CURRENT LAW—SECTION 530 OF THE REVENUE ACT OF 1978

Because of the disputes arising out of different applications of the common law rule, and to protect taxpayers in "close" cases, Congress enacted Section 530 of the Revenue Act of 1978. Although initially intended to be a temporary "patch" to maintain the status quo while Congress considered the issue, Section 530 was made permanent in 1982, and has been relied on by businesses for over 15 years.

Section 530 precludes the IRS from classifying a worker as an employee for employment tax purposes (even if the worker would be an employee under the common law rule), provided the business has a "reasonable basis" for treating the worker as an independent contractor, the business treats all similarly situated workers in the same manner, and the business has filed all required information and tax returns, e.g., Forms 1099-MISC, 941, 940, treating the worker as an independent contractor.

A business has a reasonable basis for treating a worker as an independent contractor if it is relying on a judicial decision; a revenue ruling; a private letter ruling, technical advice memorandum, or determination letter issued to it; a prior IRS audit that did not change the business' treatment of the worker; or the practice of a significant segment of the industry. Other circumstances may also constitute a "reasonable basis."

Section 530 also prohibits the IRS from issuing new regulations or revenue rulings affecting worker classification.

THE TAXICAB INDUSTRY

Like many other industries, the taxicab industry engages many independent contractors. During the 1960s, some companies, especially in urban and suburban areas, changed their method of operation. Instead of paying drivers an hourly wage, or giving the drivers a percentage of the fares recorded on the meter, companies began leasing cabs to the drivers for a fixed fee, e.g., $60 for a 12-hour period. Under the lease, the driver keeps all of the fares and tips received from passengers.

In 1971, the IRS issued two revenue rulings, Rev. Ruls. 71-571 and 71-572, concluding, *under the common law rule,* first, that drivers who leased a cab for a fixed fee, or who owned their cab and paid a fixed fee for dispatch service, will ordinarily be treated as independent contractors; and, second, that drivers who "split the meter" with the company will ordinarily be treated as employees.

For over 22 years, the industry has relied on these rulings, and many additional companies began leasing cabs to drivers. As a result, hundreds of taxicab companies in all parts of the country have obtained rulings from the IRS, concluding that drivers who lease vehicles from the company in exchange for a fixed daily or weekly lease fee are not employees for income and employment tax purposes.

WORKER CLASSIFICATION PROPOSAL

Section 7301 of the proposal would require the IRS to issue more detailed regulations governing the classification of workers as independent contractors or employees. These regulations (1) must give "significant weight" to the common law relationship between the parties, and (2) may not disturb any statutory classification rule enacted by Congress.

Section 7303 would codify Section 530 of the Revenue Act of 1978. However, in doing so, it would also significantly restrict a business' ability to rely on prior IRS audits or industry practice in determining whether workers are employees or inde-

pendent contractors. Once the regulations required by Section 7301 are effective, a business could not rely on industry practice, and reliance on a prior audit would be restricted (1) to subsequent periods when the law was the same as that for the audited year and (2) to audits that expressly considered the business' classification of the worker in question and did not require a change in that treatment.

Subchapter C should be removed from the bill for the following three reasons:

1. *Inadequate rationale.* The rationale for authorizing the IRS to issue new rules has never been adequately explained. We can certainly understand the Administration's concern that businesses will attempt to avoid the requirement to provide health insurance for workers by reclassifying employees as independent contractors. This would also tend to increase the cost of health care reform by creating new business entities that would be more likely to qualify for subsidized coverage, and by increasing the administrative costs incurred by health care alliances and other administrators to deal with more self-employed individuals.

Nevertheless, this concern is unfounded. Because, for employment tax purposes, Section 530 relief is available only when a business has consistently treated the worker as an independent contractor in all periods since 1978, Section 530 effectively counters any incentive an employer may otherwise have to reclassify employees and begin treating them as independent contractors.

2. *Precedential value.* The common law rule is long-settled, and well-known to taxpayers and practitioners. Although the IRS and taxpayers frequently dispute the appropriate classification of workers, the common law rule is such settled precedent that it should be respected and not lightly disturbed. It should not be overturned unless Congress is prepared to enact, as law (not merely authorize the IRS to issue regulations), a new rule in order to resolve a major problem. Permitting the IRS to issue a rule by regulation unfairly permits one litigant to dictate the law by which the case will be decided.

3. *No need for change.* In response to taxpayer input, the Administration's initial legislative language was modified to require the IRS regulations to give "significant weight" to the common law rule. In light of this change, additional, broadly applicable regulations are unnecessary.

The common law rule is set forth in the current regulations, and that IRS has frequently applied the rule to particular working relationships by means of revenue rulings (until 1979), and private letter rulings, technical advice memoranda, and determination letters. It may be useful to authorize the IRS to issue revenue rulings addressing common working relationships not addressed by the pre-1979 revenue rulings, provided that any new rulings are consistent with pre-1979 rulings. However, *additional regulations* applying the common law rule to particular working relationships, or giving particular weight to one or more of the 20 factors in all relationships, or in a class of relationships, are unnecessary, would be too complex, or would violate the "substantial weight" requirement.

Even the Administration has acknowledged, on page 249 of its summary of the Health Security Act, "that the new rules would not result in substantial reclassification of workers." If that is true, then any new regulations are necessary: *they would simply restate current law.*

LEGISLATIVE HISTORY

However, if the Finance Committee determines that the Treasury Department and Internal Revenue Service should be authorized to issue regulations or revenue rulings regarding the proper classification of workers, it must also provide statutory limits for the exercise of that authority. Legislative history is not enough.

The Treasury Department has testified that:

> [w]e welcome guidance from this Committee regarding appropriate parameters for the regulatory rules. We suggest that the appropriate place for guidance in developing the regulations will be in the legislative history of the Act, in recognition that it is difficult to have a specific "one size fits all" statutory definition applicable to the many varied existing worker relationships. In addition, we believe that it is desirable to maintain the continued flexibility that regulatory authority affords in an area that is as complex and dynamic as the workplace, as opposed to specific statutory rules that cannot be as easily adapted as changing work environments.

However, the importance of providing affirmative statutory rules is highlighted by the limited authority of legislative history:

> "Where, as here, the resolution of a question of Federal law turns on a statute and the intention of Congress, we look first to the statutory language

> and then to the legislative history if the statutory language in unclear." *Blum* v. *Stenson,* 465 U.S. 886, 896 (1984). The language of [the statute] is not unclear. Thus, although a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there is no need to do so here.

Toibb v. *Radloff,* 501 U.S. ——, 115 L.Ed. 2d 145, 152 (1991).

Accordingly, ITLA urges the Finance Committee to clearly specify, in the statutory language, that the Internal Revenue Service is obligated to follow, not simply "give substantial weight to," the common law rule in interpreting the Internal Revenue Code's use of the terms "employee" and "employment."

Once statutory rules are in place, the Treasury Department's proper desire to tailor the application of the law to particular worker relationships can most appropriately be met by the publication of revenue rulings, as was frequently done before 1978, not by issuing new regulations. Revenue rulings are the most appropriate tool to take into account the many factors affecting the proper classification within the context of any particular relationship, and provide the Treasury Department with the flexibility it requires, subject to the statutory rules and the regulations.

ALTERNATE PROPOSAL—SCOPE OF PROTECTION

Finally, if Subtitle C is to be enacted, the groups of workers whose classification cannot be disturbed, now limited to those who are statutorily classified under §§3506 and 3508, should be expanded.

We appreciate that the proposal now gives deference only to those workers whose classification has been determined *by Congress.* Nevertheless, many other businesses and workers have come to rely on classification determinations reached by the IRS itself in revenue rulings, private letter rulings, technical advice memoranda, and determination letters, as well as determinations by courts. Although these determinations do not carry the broad legal authority of a statutory classification, *both businesses and workers rely on them to the same degree* as do those industries that have obtained legislative "solutions."

Accordingly, if Section 7301 is to be enacted, it should preclude the IRS from affecting existing classifications that rest on any judicial precedent, IRS revenue ruling, private letter ruling, technical advice memorandum, or determination letter.

In addition, because frequently neither a business nor the IRS will have records detailing whether a prior audit expressly considered the employment classification of a worker, that proposed prerequisite to Section 530 relief should be dropped.

CONCLUSION

ITLA strongly recommends that Subtitle C be deleted from H.R. 3600. Alternately, if Subtitle C remains in the bill, ITLA would be pleased to work with you to develop expanded protection for workers already classified by the IRS and adjust the terms of Section 530. For this purpose, please contact ITLA's Executive Vice President, Alfred B. LaGasse, at our office at 3849 Farragut Avenue, Kensington, Maryland 20895; (301) 946–5700.

METROPOLITAN LIMOUSINE,
Chicago, IL, May 6, 1994.

Committee on Finance,
U.S. Senate,
Washington, DC

The purpose of my letter is to voice my concern, and that of many other members of the limousine service industry, over the practice of intentional worker misclassification. On the one side of this issue there are several limousine companies that follow the practice of classification of workers as "independent contractors." On the other side of the issue would be companies who knew from the beginning that they were engaged in an employer-employee relationship, attempted to do the correct classification and have been "penalized" for it. I say "penalized" because of the many added costs of doing business in this way, such as unemployment insurance, workman's compensation insurance, FICA and other taxes, employee benefits like health insurance and pension programs, and so on. The actual difference is that the competitor with "independent contractor drivers" can operate at an approximate 25–30% labor pricing advantage.

We have experienced this situation in the Chicago area, with a competitor who conducted surveys, fought the IRS and is protected under "safe harbor." The consequences have been the competitor does in fact charge considerably less than we are able to charge. He has made major headway into causing other operators in other parts of the country to get through audits and surveys because "everyone else is doing it, it must be common and accepted practice." The end result is an unfair trade advantage with no expiration. Furthermore, federal, state and municipal governments are deprived of the lost tax revenues each year that many of us have to pay.

The "safe harbor" issue is a major facet of the problem, as now companies who clearly meet employer-employee criteria can hide presumably forever under this protection. One method that has helped perpetuate the "safe harbor" protected company is the continuation of a small "ma and pa" type operation that might have been a small, family business ready to retire or even fail for that matter. Rather than close, the business is absorbed into the control of the large dispatch operation, who directs, bills, and advertises itself as the large company, but files 1099 forms, avoiding all the taxes and costs of maintaining employees.

The need to put businesses on an equal plane demands that some limit be put on the "safe harbor" allowances. I hope that this will become a part of the Senate Finance Committee's agenda, given some of the abuse I have cited here, and have experienced.

I also wonder if there has been any thought given to the worker who is classified "independent contractor" who is injured, becomes disabled, becomes ill and needs health care, or who will ultimately want to retire and have no place to go for care but maybe the government. I hope not, as protection of federal and state programs such as OSHA, ADA, and EEOC are non-existent. Some form of welfare will have to be devised to take care of the legitimate and "safe harbor" independent contractors because Social Security and Medicare will not qualify.

I appreciate this opportunity to voice my concern to the Committee on Finance; and I hope that my comments will help the Committee to understand that there is a problem with the way things are today. Thank you for your consideration in this matter.

Sincerely,

THOMAS N. MULLIGAN

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Committee: The National Association of Home Builders (NAHB) and its 170,000 members, appreciates the opportunity to present our views. This statement will address the proposals contained in the Administration's Health Security Act with respect to classification of workers as employees or independent contractors.

At the outset, NAHB would like to point out that we recognize that the government has long been concerned with improving the efficient collection of revenue with respect to errors in the classification of workers. We also recognize that the administration believes that the Health Security Act's requirement that employers pay a significant share of their employees' health insurance premiums, and the Act's provision for premium discounts based on average payroll and the number of employees, will increase the importance of proper classification of workers as either employees or independent contractors.

The government further believes that, in the context of health care, section 530 of the Revenue Act of 1978 could foster manipulation and abuse of both the requirement that employers pay a portion of their employees' health insurance premiums and the payroll-based premium based discount rules. Nevertheless, NAHB believes that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

Further, NAHB has adopted firm policy in opposition to (a) an employer mandate as a vehicle to provide health insurance/universal coverage to all employees and (b) any attempt to reclassify independent contractors as employees for the purpose of mandating health care coverage. We believe that the current law pertaining to worker classification recognizes the unique characteristics of the home building business and allows the flexibility necessary for building industry workers to function in a changing economy. Moreover, the current rules under Section 530 of the Revenue Act of 1978 provide equitable relief for taxpayers who become involved in disputes with respect to worker reclassification.

INDUSTRY PROFILE

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

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 job sites necessarily change as the homes are built, the relationship between the home builder and the person who performs the different trades varies widely. Another complicating factor, principally from the standpoint of the approach the Internal Revenue Service has made to many homebuilders, is the fact that a home builder routinely does "sub-out"—that is, hire an independent contractor to perform services which may, in the minds of the IRS, constitute performance of "common labor." In those instances, the IRS often alleges that the person is an employee rather than an independent contractor. The construction of single family homes is basically the coordination of the work of as many as 18 different subcontractors.

Since the volume of work in the homebuilding industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. In today's market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships. During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

A builders' organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 8 percent of the medium- and large-volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships.

LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform all the operations it takes to develop land and build and market homes. According to NAHB's 1987 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work and sell through real estate agents.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 55 percent by 1987. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 14 percent. Large-volume builders tend to subcontract a larger share of the construction cost. Builders in the South use subcontractors for a larger share of construction than builders in the Northeast, Midwest, and West. NAHB's 1987 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary

working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. An NAHB survey of builders in 1987 showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1987 Census of Construction indicated that residential builders subcontracted $41 billion, or 40 percent of the value of their construction receipts. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 15 different subcontractor firms.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials, so the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

Most builders are small firms. The majority of home builder members of NAHB build less than 10 homes per year. The majority of subcontractor firms are similarly small, although it is not uncommon for a subcontractor firm to be larger than the builders for whom it works.

In 1987, there were 1.4 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 342,000, had total receipts of $204 billion, while the 1.06 million establishments with no payroll had receipts of $34 billion. Out of total receipts, about 35 percent went toward the purchase of materials and supplies and another 7 percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that's equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 -percent of their dollar volume to work done by subcontractors and 5 percent subcontracted 100 percent. of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

CONSEQUENCES OF CLASSIFICATION

Reclassification of subcontractors as employees would:

1. Add substantially to the cost of doing business of the small home builder;
2. Remove the flexibility of the owner to respond to a volatile market and seasonal conditions;
3. Shift the nature of the home building business from small business to a concentration of large firms;

4. Would add substantially to the cost of housing driving thousands of protected buyers out of the market.

TREASURY AUTHORIZATION TO ISSUE NEW CLASSIFICATION RULES

The Health Security Act would authorize Treasury to issue new rules for determining the classification of workers for health care and employment tax purposes. We understand that the regulatory rules would not override other statutory classification provisions already in the Code and would be required to give significant weight to the common law applicable in determining the employer-employee relationship.

Generally, classification of a worker as an employee or an independent contractor turns on the common law definition of "employment. " In order to characterize workers, common law principles, statutory rules of workers' compensation, and employer tort liability as well as the twenty-factor test, developed by the Internal Revenue Service, must be reviewed.

NAHB believes that any limitation on the standards for determining employment would so restrict the independent contractor classification as to exclude subcontractors who, pursuant to industry custom should legitimately and properly be so classified. NAHB believes that if the IRS is permitted to narrow the factors examined in determining whether an employer-employee relationship exists, the resulting rules would favor classification of the worker as an employee. NAHB opposes any governmental effort to encourage businesses to classify independent contractors as employees.

NAHB further opposes any proposal to broaden the other "employee laws" (e. g. minimum wage, workers' compensation, unemployment taxes) to include independent contractors. Any such change would be antithetical to the free-enterprise concept to which independent contractor status is attributed. Moreover, it would change the nature of the homebuilding business and drive the cost of housing beyond the reach of millions of first-time homebuyers.

SECTION 530 OF THE REVENUE ACT OF 1978

The bill would incorporate and modify the safe-harbor provisions of section 530. Under the proposed rules, the IRS would be permitted to reclassify misclassified workers on a prospective basis. The employer would be protected from retroactive reclassification if the employer satisfied the modified safe harbor provisions.

Although we agree that the modifications proposed with respect to the consistency and return-filing requirements would ensure consistent application of the provision to similarly situated taxpayers, we oppose the other proposed changes to section 530 relief.

NAHB particularly opposes the modification and proposed elimination of the "industry practice" safe harbor. The proposal provides for the termination of this safe harbor at the time of issuance of regulations and guidance as to classification of workers in the home construction industry. This safe harbor is of direct and significant import to the building industry. Its' termination would be most harmful to businesses and regions which customarily "sub-out" to independent contractors under factual circumstances which may not satisfy the twenty-factor test or the anticipated IRS standard for "industry practice."

Finally, NAHB fully supports the proposition that every American must pay his full share of Federal income tax.

Independent contractors employed in the home construction industry generally satisfy the current 20-factor test. Indeed, "bogus" or fraudulent contractors who have been forced into that status illegally and against their will and who have no idea about the responsibilities of being self-employed would most certainly not pass the current IRS standard for classification as independent contractors.

Increased IRS compliance activity would unveil dishonest construction contractors and level the playing field for honest construction employers. Indeed, as pointed out during testimony on this issue before the House Committee on Ways and Means Subcommittee on Select Revenue Measures, the same worker, (e.g., a "building framer") employed on a union construction site, could legitimately perform work for a home builder as an independent contractor, because of the unique nature of the homebuilding industry. It is the job of the Internal Revenue Service to resolve the compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements. In this regard, NAHB agrees with the proposals to increase IRS enforcement efforts by increasing penalties for failure to file Forms 1099.

MODIFICATION OF SELF-EMPLOYMENT TAX TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS AND PARTNERS

The bill would amend the definition of net earnings from self-employment subject to self-employment taxes to include the pro rata share of certain S corporation income of certain shareholders and modify the definition of net earnings from self-employment as applied to limited partners in a partnership for self-employment tax and health insurance premium purposes.

Under the bill, any more than two percent shareholder in a service-related business, who materially participates would be treated as having "net earnings from self-employment" equal to his or her distributive share from the service-related business. Similarly, for limited partnerships, earnings from the partnership would be treated as "wages" for premium discount purposes. The shareholder's pro rata share of the income or loss of an S corporation would be determined pursuant to the general rules of subchapter S. Thus, the shareholder's payroll taxable income would include elements of return on capital invested in the business and would apply irrespective of whether the income is distributed.

The term "service-related business" would be any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees." The term generally includes the activities of certain professions that are more dependent on personnel skills than upon capital investment. The construction and sale of a home is the sale of a tangible asset, and is not at all similar to the services rendered by an architect or engineer.

As stated above, the industry, building single family housing, is comprised mostly of small businessmen and women. According to our 1993 Health Care Survey approximately 37% of those businesses with an employee on payroll operate as S corporations and 5% operate in partnership form. Although coverage of this provision is not at all clear and may include a number of businesses normally not considered "service related," clearly, building construction should not be a covered activity. The proposed dramatic change in tax policy, if made applicable to homebuilders, would have the most direct and harmful impact on builders who can least afford to sustain an additional hidden tax increase. Indeed, the proposal would unfairly penalize entrepreneurship and capital investment.

CONCLUSION

NAHB urges the Administration and Congress to create an environment which will encourage, support and provide incentives to our free enterprise system through a market-based approach to health care reform that will:

1. Provide universal access to health insurance for legal residents, rather than guaranteed/mandated coverage,
2. Improve access to health care at the individual level by providing a refundable tax credit for health expenses for low-and moderate-income Americans; permanently increase the tax deduction for health insurance costs of the self-employed from 25 percent to 100 percent; and promote tax-deferred individual medical savings Individual Retirement Accounts ("Medisave" accounts),
3. Enact meaningful medical malpractice reforms,
4. Promote cost containment,
5. Preserve existing association-sponsored health programs as viable mechanisms for pooling risks and increasing the market leverage of small employers.

For the reasons set out above, NAHB strongly opposes any modification to the existing rules which would result in reclassifying independent contractors as employees for the purpose of mandating health care coverage and a broad employer mandate as the vehicle to provide health insurance/universal coverage to all employees. NAHB further opposes any attempt to change the treatment of Subchapter S and partnership income to increase taxes to pay for health care.

The National Association of Home Builders is much appreciative of having had this opportunity to present our views on the classification of workers as employees or independent contractors and the subchapter S corporation shareholder provisions of the Health Security Act.

STATEMENT OF THE NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

I am Bennie L. Thayer, President and Chief Executive Officer of the National Association for the Self-Employed (NASE). The NASE represents over 320,000 small

business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting services and retail fields.

On behalf of the NASE, I am pleased to submit this statement for the record regarding the independent contractor provisions of S. 1757, President Clinton's health care proposal. This bill (entitled, the "Health Security Act") includes provisions which would generally permit the IRS to issue prospective regulations to determine who is an employer and employee for purposes of both health care and all federal employment tax matters. The NASE agrees with the goals of health care reform that President Clinton outlined in his speech to Congress last fall. We are concerned, however, that the independent contractor provisions of the proposed Health Security Act would impede these goals.

We believe that any attempt to dramatically restructure the tax treatment of independent contractor status would be a major and unnecessary distraction from the broader health care debate. To the extent Congress begins a review of independent contractor status, such an investigation should be conducted on a separate track from health care. The independent contractor matter is too complex a tax issue to be discussed as a sidelight to health care reform.

THE NASE POSITION ON HEALTH CARE REFORM

Many proponents of S. 1757 argue that the Administration's independent contractor provisions are inextricably linked to the employer mandate concept. The NASE strongly disagrees with this position. We believe that broad-based and meaningful health care reform can be accomplished without enacting an employer mandate or by adding additional burdens on independent contractor status. [1]

Unfortunately, it is this heavy reliance on an employer mandate which pushes the bill sponsors towards modifications in the tax treatment of independent contractors. This is but one of many reasons why NASE believes reliance on an employer mandate would be a serious mistake.

SECTION 530 OF THE 1978 REVENUE ACT

Section 530 of the Revenue Act of 1978 was the last time Congress passed broad legislation addressing the issue of who is an independent contractor and who is an employee. Although Section 530 clearly has flaws, it does provide employers with a safe harbor for determining who is an independent contractor. The statute also imposes a moratorium on any IRS regulations involving independent contractor status.

This existing law provides employers with relief from potential IRS reclassification of a firm's independent contractors as employees by prohibiting the IRS from reclassifying such workers if the employer has a reasonable basis for its treatment of the workers as independent contractors. A reasonable basis includes reliance on (1) judicial precedent or IRS rulings, (2) a past IRS audit in which there was no assessment attributable to employment taxes, and (3) a long-standing industry practice in treating the workers as independent contractors.

Section 7303 of the proposed Health Security Act makes substantial changes in these safe harbors. Among other changes, the legislation repeals the "industry practice" safe harbor once the Internal Revenue Service issues new independent contractor regulations. This change alone would transform, overnight, the job status and future employment viability of millions of Americans. The NASE strongly opposes any such wholesale change in the total tax treatment of independent contractors. Such an massive reorientation cannot be accomplished in a fair and equitable fashion when inter-mixed with the largely unrelated issues and timetable of health care reform.

THE ADMINISTRATION'S PROPOSALS REGARDING INDEPENDENT CONTRACTOR REGULATIONS

Section 7301 of the Health Security Act provides the IRS with authority to issue prospective regulations on independent contractor status "in order to prevent the misclassification of workers" by businesses or persons seeking to "minimize payment" under the Administration's initiative. The regulations would not be limited to situations relating to health care premiums, but would also be applicable to all issues related to employment taxes. Further, Section 7302 increases the tax pen-

[1] Mr. Bennie L. Thayer, President and Chief Executive Officer, National Association for the Self-Employed, before the Committee on Ways and Means, U.S. House of Representatives, February 3, 1993.

alties associated with information returns and independent contractor status. The NASE views these provisions as a dangerous and open-ended grant of authority to the Service.

The NASE is fully supportive of the notion that all taxpayers should pay their fair share of taxes. In addition, as addressed below, we do support efforts by Treasury and the IRS to identify areas of potential abuse with respect to employment classification issues. Nevertheless, given the complexity of such a task, we do not believe that such a study can be objectively accomplished within the constraints of the health care debate.

Congress has grappled with the independent contractor issue both in 1978 and again in the early 1980s. Both times, Congress found the independent contractor issue extremely divisive and complicated—even without the added difficulty of health care reform. For this reason, NASE does not believe a fair and equitable solution can be crafted for this issue in a short time period, and clearly not within the 3 to 6 month time span that most experts believe it will take Congress to pass a final health care initiative.

The NASE strongly opposes a carte-blanche grant of authority to the IRS to issue independent contractor regulations. Without clear and unambiguous safeguards built into the law, we believe that such a broad grant of authority is equivalent to "putting the fox in charge of the hen house."

Small business has had a long-standing policy of supporting clarification of independent contractor status. But the objective of that policy should be to accommodate changes in the U.S. and global economies toward more—not less—flexibility in employment and contracting arrangements. Small business' concerns have been fueled by the vigorousness of IRS payroll tax audits focussing on employment classification issues.

In response to the intensity with which the IRS has pursued independent contractor audits, the NASE has previously called upon Congress to take steps to foster the nation's entrepreneurship base—and not look for ways to impede the availability of independent contractor status. In the absence of stringent safeguards built into the law, we view the independent contractor provisions of the Health Security Act as a step in exactly the wrong direction—as well as a significant impediment to economic growth and to the entrepreneurial spirit.

CONGRESSIONAL INVESTIGATION OF INDEPENDENT CONTRACTORS

The NASE does support the idea of a separate Congressional investigation regarding the tax treatment of independent contractors. But we believe that clear objectives must be set before such an investigation is undertaken. Any Congressional inquiry of this type should be premised on the need to foster and promote independent contractor status—as opposed to heavily restricting its use.

Once such an economic impact or review has been completed, the NASE would support a review of the 20 factor test now utilized in determining independent contractor status. This 20 factor test centers around an analysis of the degree to which a service recipient has control over a worker and the services provided by that worker.

The NASE and others in the small business community can agree with the Treasury Department when it calls this 20 factor test subjective. In testimony before the House Government Operations Committee last year, Treasury Deputy Benefits Tax Counsel J. Mark Iwry stated that the 20 factor test has been "criticized as leading to imprecise and unpredictable results . . . " Also as part of that testimony, Iwry provided a lengthy discussion of what the Treasury called the consequences of worker misclassification. Iwry even stated that "Deliberate misclassification . . . may tend to result in net revenue losses to the extent misclassification is undertaken to obtain a net tax benefit for the employer and the worker."[2]

The NASE does not and will never condone deliberate misclassification of workers. We do not believe Congress should condone such activity. But if Congress is primarily concerned about short-term budgetary impacts resulting from what Treasury calls worker misclassification, then the nation's legislative body can rest easier. Iwry further stated in his testimony last year that "it is impossible to determine *a priori* whether misclassification tends, on average, to result in a net revenue gain or loss."

Iwry noted a very significant reason for his revenue impact analysis. He stated *"current Federal tax law does not consistently favor status as either an employee or an independent contractor."* In other words, workers end up paying about the same

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[2] Mr. J. Mark Iwry, Deputy Benefits Tax Counsel, Department of Treasury before the Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations, U.S. House of Representatives, June 8, 1993, page 6.

taxes either way. Assuming this logic carried through to health care, it is probable that Treasury would similarly find it difficult to determine any net revenue gain or loss from worker misclassifications on the overall health care budget.

This is another important reason why making hasty legislative or regulatory changes in the tax treatment of independent contractors or workers is ill advised. Given the revenue uncertainty, Congress should remain cautious about making snap changes in independent contractor status. Hasty changes in the law and regulations can have dramatic and potentially harmful impacts on millions of small business persons and the nation's work force as a whole.

A "SLEEPER" INDEPENDENT CONTRACTOR PROVISION OF S. 1757

The President's health care bill requires a self-employed person to make premium payments to a regional health alliance based on a certain formula. It the NASE's understanding that. under this formula, a self-employed person would generally pay "employer" premiums (to cover his or her family's own health care needs) equal to 7.9 percent of his income and "employee" premiums equal to 1.9 percent of income, subject to a cap based on the average cost of a family plan in the alliance area.

Even when coupled with an increase in a self-employed person's health insurance deduction from 25 percent to 100 percent, we believe this formula is likely to result in a significant increase in the health insurance costs for any family in which there is both a self-employed individual and a working spouse. In other words, the President's plan requires both the self-employed individual and his or her working spouse to pay health insurance premiums.

Section 6126 of H.R. 3600 contains this "sleeper' provision impacting upon self-employed persons. On the one hand, Section 6126 appears to place a cap on the out-of-pocket health insurance costs of the individual who is also employed full-time. The Health Security Act provides this individual with a credit based on the amount of health insurance premiums paid by his employer for the year.

Taken at face value, Section 6126 should be considered pro-entrepreneurial and pro-growth. That is, the provision attempts to reduce the level of risk associated with an individual starting his or her own business. On the other hand, however, the legislation also appears to *potentially eliminate* this credit for any self-employed individual who has income that exceeds 250 percent of the applicable poverty level. Presuming that $15,000 constitutes the national poverty level in 1993 for a family of four, a self-employed individual earning more than $37,500 in a given year potentially loses the protection of the cap.

The bill goes on to reduce or eliminate this cap on out-of-pocket health insurance costs if the self-employed individual is (1) a substantial owner and employee of a closely held business and '2) the individual is engaged in "sham or secondary employment arrangements."

The NASE is very concerned about this particular provision for a number of reasons. First, it is the National Health Board which is given the authority under the legislation to determine what constitutes "sham or secondary employment arrangements." This is a dangerous grant of authority to a national board of unelected officials whose expertise is supposed to be health care, not tax policy. The NASE firmly believes that Congress alone should have the authority to define what constitutes a legitimate business practice. Second, by virtue of the use of words like "secondary employment arrangements," the health care legislation seems to be revealing an underlying tone of hostility toward independent contractor status.

Especially troubling is the prospect that the self-employed person may have to share confidential personal income and tax data with any potential contracting individual or business. It is difficult to see how individuals and firms wishing to contract with self-employed people could risk the cost consequences of contracting with a person who might be reclassified, months or years later, as an employee. The only way to avoid such a risk—and even then not to entirely avoid it—is for the self-employed person to make all of his or her income records available to any potential contractor. This is a scenario which would be inequitable, dampening to entrepreneurial spirit, and likely to impose vast, complex recordkeeping burdens on tens of thousands of start-up small businesses. It strongly suggests to us that individual-based health insurance, rather than employer-based health insurance, would make much more sense for the self-employed and for owners of very small businesses.

CONCLUSION

The health care debate is not the place nor the time to evaluate the full range of policy issues surrounding independent contractor status. If this potential effort to overturn past precedent on independent contractor status remains part of any final health care bill, Congress and the Administration should expect the small business

community to unleash a fury of activity in opposition to these provisions contained in the health care legislation. We believe this scenario would likely result in a "call to arms" by major small business associations, creating a major distraction away from the critical debate over what form the nation's health care system should take going into the twenty-first century.

STATEMENT OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

The National Federation of Independent Business appreciates this opportunity to submit testimony on the issues of independent contractors and modification of the tax treatment of S Corporations. In addition, attached is a copy of the testimony of one of our members before the House Ways and Means Committee on the issue of independent contractors. NFIB is the nation's largest small business advocacy organization, representing 600,000 small and independent business owners nationwide.

INDEPENDENT CONTRACTOR ISSUE

NFIB has a strong interest in the independent contractor issue since we represent both independent contractors and the businesses that hire them. Consequently, we have actively participated in the debate on independent contractor status over the last decade. The issue of worker classification is of particular importance to NFIB members since smaller businesses are in greater need of the flexibility that independent contractors provide. In fact, our Office of Membership Liaison has received more complaints and comments from our members on this issue than they have on any other tax-related subject.

The solution to this problem, however, does not lie in giving the Internal Revenue Service (IRS) virtually unlimited authority to classify workers. The IRS has a strong institutional bias against independent contractors, and it is likely to severely limit the number of workers who will be able to work as independent contractors.

THE IMPORTANCE OF INDEPENDENT CONTRACTORS

Independent contractors are men and women who have decided to work for themselves instead of working for an employer. They are found in a wide variety of industries. They usually control their own hours, work with their own equipment, and are not subject to the direct control of the person hiring them. An independent contractor is a budding small business owner. Deciding to work as an independent contractor is often the first step toward establishing a business with employees of its own. Federal tax law should not discourage hard-working Americans from starting their own businesses by preventing them from working as independent contractors.

Independent contractors play a very important role in our economy and in the operation of small businesses across the country. From a small business owner's standpoint, independent contractors serve a variety of functions that are not easily performed by employees. They allow a small business owner to temporarily hire someone with a skill that is needed by the business for a short period of time or on an occasional basis. It is not unusual for a business to have a variety of jobs arise during the year that cannot be handled with the current work force but that do not require hiring an additional employee. By hiring an independent contractor, a business owner can have the job taken care of quickly without having to hire someone that may have to soon be let go.

MAKING A BAD SITUATION WORSE

Small employers are very concerned about the cloud of vagueness and uncertainty that envelopes the current definition of an independent contractor. They are even more concerned, however, about giving the IRS the authority to determine, on its own, which workers will be independent contractors.

The IRS has a strong institutional bias against independent contractors. Independent contractors make tax enforcement more difficult because the taxes they owe are not withheld. Independent contractors are more likely to under report income and overstate deductions. Independent contractors are sometimes difficult for the IRS to find. These compliance problems, however, are just that; they do not justify severely limiting the number of independent contractors in the work force.

Worker classification is a policy issue of major public importance. It is not a decision that should be left to the regulatory authority of an agency. This issue is too complicated and too important to our economy to be treated in such an off-handed manner. We would be happy to work with the Committee to legislatively simplify and define just who is or is not an independent contractor.

MODIFICATION OF THE TAX TREATMENT OF S CORPORATIONS

NFIB is concerned with the proposed changes in the tax treatment of service industry S Corporation shareholders and partners. Subchapter S Corporations and partnerships were originally created to avoid the dual layer of taxation imposed by regular C Corporations and to take advantage of lower rates for individuals. In the past, this single tax level and lower tax rates made subchapter S Corporations a popular way to set up a new business.

Under current law, the profits of the business are treated as dividends and are subject to income taxes, but are not considered wages or self-employment earnings. The Health Security Act fixes into law the concept that an S Corporation which operates in a service industry must treat all income of the S Corporation shareholders, with more than a 2 percent interest in the S Corporation, as self-employment income. The Act makes no distinction between whether the income was distributed to the shareholder or reinvested in the business.

NFIB has further concerns that under the Health Security Act, the salary paid to the shareholders would be irrelevant, the way profits were used by the company would be irrelevant, and the capitalization of the company would be irrelevant. It all would simply be characterized as self-employment income and subject to self-employment tax, the Medicare HI Tax, and the new 7.9 percent payroll tax to be imposed under the Act, without limit.

TREATMENT OF LIMITED PARTNERS

Under current law, a taxpayer holding both a general partnership share in a business and a limited partnership share need not pay employment taxes on the limited partnership share. NFIB has concern that under this section of the Act, a partner will be required to pay employment taxes on the limited partnership share.

CONCLUSION

NFIB strongly believes that Congress must simplify the definition of an independent contractor. Small employers hiring independent contractors need to be able to determine whether or not a worker will later be reclassified as an employee and the employer be subject to penalties. As long as employers are subject to any tax liability for incorrectly classifying a worker as an independent contractor, they will be in need of a clear, simple definition of who the IRS considers to be an independent contractor.

The crafting of a simpler definition should not be left solely in the hands of the IRS. Although the IRS could come up with a definition that is much simpler, that definition could also be so restrictive that it would noticeably mitigate the positive impact independent contractors have on our economy. The worker classification debate is too important and too complicated to try to resolve it as part of a larger debate on health care.

Without an employer mandate, the need for the IRS to classify workers and the need for modification of the tax treatment of S Corporations dissipates. NFIB urges this Committee to eliminate the employer mandate from the President's, and any health care bill it considers, and address the issue of worker classification separately from health care where it can be considered in greater detail.

PRO COURIER AND MESSENGER,
Phoenix, AZ, May 11, 1994.

Committee on Finance,
U.S. Senate,
Washington, DC

Statement for the record: Misclassified workers

I operate in an industry that is infested with irresponsible employers. Business owners that intentionally misclassify their workers as independent contractors. By doing so they avoid all expenses related to having employees; payroll taxes, worker compensation insurance premiums and any other benefit associated with the traditional employer/employee relationship.

Intentional is the key word. Workers are forced into a position of self-employment. Intentional misclassification is exploitation in its purest form. The only winner in this controversial relationship is the greedy tax cheating employer. The worker, society and the public treasury are the big losers.

Independent contractors are not protected by the safety net intended for all American workers. Contractors are 100 percent on their own. They are not provided any benefit connected with their employment. Contractors are not covered by any federal labor laws. Injured on the job, too bad. Laid off, no unemployment benefits. Contractors can be paid less than minimum wage and not paid time and a half for overtime. They're not even protected by civil rights laws. Misclassified workers often develop income tax problems. Some file but cannot pay, many simply do not report their income at all. Responsible employers and society pay for those who don't.

If the national health care plan includes an employer mandate, intentional misclassification of workers will intensify. It has already reached epidemic level in many industries. As the cost of labor continues to rise, honest businesses that pay taxes and create real jobs will fail. Crafty capitalists who operate outside the system will continue to profit.

Taxpayers are getting raped by companies that intentionally misclassify their workers. Taxpayers have to compensate for the deficit created by the cash under the table method of payment. Taxpayers are getting justifiably angry. The problem of worker misclassification is widespread and pervasive. Something can be done to eliminate this cancer.

Section 530 of the Internal Revenue Code has got to go. It's created a situation that's ridiculous. Companies that have intentionally misclassified their workers for years are allowed to continue to do so. The IRS is not permitted to issue opinions or rulings clarifying regulations on worker classification. Section 530 perpetuates the underground economy. If it's not repealed, a lot more people are going to lose their conscience and go underground.

Respectfully,

GARY P. BABBITT, *President, PC&M*

STATEMENT OF THE S CORPORATION COALITION

The S Corporation Coalition is a group of 13 companies from all over the country, in a wide range of businesses, that are concerned with tax legislation affecting S corporations. The Coalition opposes the modification to the self-employment tax treatment of S corporations (Section 7141 of S. 1757 of the Health Security Act) because it unfairly discriminates against certain S corporations by taxing their return on investment as wages, subject to self-employment taxes and higher premiums under the Health Security Act. It is inappropriate to impose this substantial tax increase on S corporations. S corporations include primarily small and medium-sized businesses that have been the major contributor to the growth of the U.S. economy over the last several years, and this tax increase will impede growth.

Under Subchapter S of the Internal Revenue Code, an S corporation's earnings are subject to only one level of tax, at the shareholder level, rather than being taxed at the corporate level and again when income is distributed to shareholders. A shareholder-employee, however, is separately taxed on his/her income from services performed by the shareholder-employee because the corporation pays (or is deemed to have paid) salary to such person. For S corporations, net earnings after reduction for wages is deemed to be distributed to individual shareholders, and tax is imposed on those earnings even if the earnings are reinvested in the business. However, the result of the Administration's proposal in the Health Security Act is to tax a shareholders' return on his investment as wages, which violates the basic tax principle distinguishing capital income from labor income. This proposal appears to be based on an assumption that the income earned by owners of a personal service business is generated by the labor of the owners. This assumption is wrong. Many of the service businesses in the S Corporation Coalition have large numbers of employees, but less than 35 shareholders. The shareholders clearly have invested capital in expanding employment, and the income earned by the S corporation is not the result of the labor of the shareholders. Furthermore, over the years, personal service businesses have changed the way they do business and rely increasingly on capital investments. Today's service businesses invest heavily in computers, communications equipment and other technologically advanced equipment which make them more productive and efficient.

President Clinton's health care reform bill—the Health Security Act—would extend self-employment taxes to the income that flows through from certain service-oriented S corporations. As a result of this modification, S corporation shareholder-employees in the specified service industries would pay self-employment taxes, including the 2.9% self-employment tax for Medicare, on the earnings of the corporation, in addition to the employment taxes imposed on their salaries. This tax will

fall on the earnings of S corporations that in many instances would otherwise be reinvested in the business—to buy a new machine, to hire a new employee or to expand the business.

An example illustrating the effect of this proposal is included in the Appendix.

We understand that the Treasury Department has suggested that this provision is necessary to prevent S corporation shareholder-employees from artificially lowering their compensation in order to reduce their self-employment taxes. This provision, however, is overly broad and is not needed to police the perceived abuse that might be undertaken by at most a small group of aggressive taxpayers. Specifically, this provision applies to all S corporations involved in certain service industries without regard to whether they engage in this aggressive tax planning. As a result, it will unfairly penalize a large group of S corporation shareholder-employees that are paid adequate wages and pay the appropriate amount of self-employment taxes in order to prevent a small group of aggressive taxpayers from abusing the system. Furthermore, the Internal Revenue Service already possesses the necessary weapons to combat this abuse. For just a sampling of the Service's successful monitoring of this area, *see* Revenue Ruling 74–44, 1974-1 CB 287; *Radtke* v. *U.S.*, 712 F. Supp. 143 (ED Wis. 1989); *C.D. Ulrich, Ltd.* v. *U.S.*, 692 F. Supp. 1053 (D. Minn. 1988); *Spicer Accounting, Inc.* v. *U.S.*, 918 F2d 80 (9th Cir. 1990); and the discussion in Eustice and Kuntz, *Federal Income Taxation of S Corporations* (3rd Edition, Warren, Gorham & Lamont, 1993) ¶11.02.

The S Corporation Coalition believes the additional tax on earnings as proposed by the Health Security Act will hinder expansion by small business because less income will be available for reinvestment. Many of the businesses that would be negatively impacted by this provision already face a substantial tax increase from the 1993 Tax Act. In addition, this proposal will not further sound tax policy or administration because it will inappropriately penalize taxpayers that are not engaging in the perceived abuse.

The Health Security Act also would include the non-wage income of these S corporations as wages for purposes of determining the maximum health care premiums the business must pay under the Health Security Act. This would result in a substantial increase in the health care premiums that an S corporation would have to pay for all of its employees and is inappropriate. An example illustrating the effect of this proposal is included in the Appendix.

The S Corporation Coalition respectfully requests that the Committee carefully study the impact of this proposal to tax earnings of a business as wages on small business and reject it. The Coalition believes this proposal is unfairly targeted to small businesses and will harm capital formation.

APPENDIX

EXAMPLE OF EFFECT OF CHANGE IN DEFINITION OF WAGES ON INCOME AVAILABLE FOR REINVESTMENT IN AN S CORPORATION

Suppose an S corporation engaged in a service business employs 50 people, each of whom generate $10,000 of income in excess of his/her salary and other expenses. Assume further that all of the stock of the S corporation is owned by one individual that has worked in the business for years and she generates $100,000 of income for the corporation. Also assume that she has consistently been paid compensation of $100,000 from the corporation. Finally, assume that the S corporation only makes distributions to the shareholder that are necessary to enable her to pay her taxes—all remaining amounts are reinvested in the business. This S corporation would have $500,000 in taxable income after the deductions for wages. Prior to the Tax Act of 1993, the corporation would have had to distribute approximately $155,000 to the shareholder to enable her to pay her taxes on the income of the corporation (31% of $500,000), leaving $345,000 to reinvest in the business.[1] After the Tax Act of 1993, the corporation would have to distribute approximately $200,000 to the shareholder to enable her to pay her taxes on the income of the corporation (40% of $500,000), leaving $300,000 to reinvest in the business. In addition, the shareholder-employee's $100,000 compensation would be subject to higher self-employment taxes. If the Health Security Act extends the self-employment taxes to the income of the corporation, the corporation would have to distribute approximately $215,000 to the shareholder to enable her to pay her taxes on the income of the corporation, leaving $285,000 to reinvest in the business. This would be the case even

[1] For purposes of this example, it is assumed that the shareholder-employee has sufficient income from other sources to make her income from the S corporation subject to the highest marginal rates.

though this shareholder-employee did not engage in the abuse feared by the Treasury Department.

EXAMPLE OF EFFECT OF CHANGE IN DEFINITION OF WAGES ON HEALTH CARE PREMIUMS

Suppose a business has 50 employees that each earns $20,000, and each is married with children. Suppose also that this business happens to be an S corporation with one owner that is actively engaged in the business and receives a salary of $75,000. Finally, suppose that after paying total salaries of $1,075,000 as well as other expenses the business generates $325,000 of profit.

Under Section 6123(f) of the Health Security Act, the "payroll" limitation (for purposes of determining the maximum premiums that must be paid) would include profit earned by the owner of a business. In this example, $325,000 of profit would be included in the "payroll" limitation, increasing it from $1,075,000 to $1,400,000. Generally, under the Act, health security premiums are limited to a specified percentage (up to 7.9%) of "payroll." In this example, the maximum amount of premiums that this employer must pay is 7.9 percent of average annual wages. Thus, as a result of the inclusion of profit as wages, this business's maximum health security premiums will increase from $84,925 to $110,600, an increase of over 30 percent.

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