

20 Common Law Factors

Rev. Rul. 87-41, 1987-1 CB 296

ISSUE

In the situations described below, are the individuals employees under the common law rules for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24 respectively, subtitle C, Internal Revenue Code)? These situations illustrate the application of section 530(d) of the Revenue Act of 1978, 1978-3 (Vol. 1) C.B. 119 (the 1978 Act), which was added by section 1706(a) of the Tax Reform Act of 1986, 1986- 3 (Vol. 1) C.B. 698 (the 1986 Act) (generally effective for services performed and remuneration paid after December 31, 1986).

FACTS

In each factual situation, an individual worker (Individual), pursuant to an arrangement between one person (Firm) and another person (Client), provides services for the Client as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Situation 1

The Firm is engaged in the business of providing temporary technical services to its clients. The Firm maintains a roster of workers who are available to provide technical services to prospective clients. The Firm does not train the workers but determines the services that the workers are qualified to perform based on information submitted by the workers.

The Firm has entered into a contract with the Client. The contract states that the Firm is to provide the Client with workers to perform computer programming services meeting specified qualifications for a particular project. The Individual, a computer programmer, enters into a contract with the Firm to perform services as a computer programmer for the Client's project, which is expected to last less than one year. The Individual is one of several programmers provided by the Firm to the Client. The Individual has not been an employee of or performed services for the Client (or any

predecessor or affiliated corporation of the Client) at any time preceding the time at which the Individual begins performing services for the Client. Also, the Individual has not been an employee of or performed services for or on behalf of the Firm at any time preceding the time at which the Individual begins performing services for the Client. The Individual's contract with the Firm states that the Individual is an independent contractor with respect to services performed on behalf of the Firm for the Client.

The Individual and the other programmers perform the services under the Firm's contract with the Client. During the time the Individual is performing services for the Client, even though the Individual retains the right to perform services for other persons, substantially all of the Individual's working time is devoted to performing services for the Client. A significant portion of the services are performed on the Client's premises. The Individual reports to the Firm by accounting for time worked and describing the progress of the work. The Firm pays the Individual and regularly charges the Client for the services performed by the Individual. The Firm generally does not pay individuals who perform services for the Client unless the Firm provided such individuals to the Client.

The work of the Individual and other programmers is regularly reviewed by the Firm. The review is based primarily on reports by the Client about the performance of these workers. Under the contract between the Individual and the Firm, the Firm may terminate its relationship with the Individual if the review shows that he or she is failing to perform the services contracted for by the Client. Also, the Firm will replace the Individual with another worker if the Individual's services are unacceptable to the Client. In such a case, however, the Individual will nevertheless receive his or her hourly pay for the work completed.

Finally, under the contract between the Individual and the Firm, the Individual is prohibited from performing services directly for the Client and, under the contract between the

Firm and the Client, the Client is prohibited from receiving services from the Individual for a period of three months following the termination of services by the Individual for the Client on behalf of the Firm.

Situation 2

The Firm is a technical services firm that supplies clients with technical personnel. The Client requires the services of a systems analyst to complete a project and contacts the Firm to obtain such an analyst. The Firm maintains a roster of analysts and refers such an analyst, the Individual, to the Client. The Individual is not restricted by the Client or the Firm from providing services to the general public while performing services for the Client and in fact does perform substantial services for other persons during the period the Individual is working for the Client. Neither the Firm nor the Client has priority on the services of the Individual. The Individual does not report, directly or indirectly, to the Firm after the beginning of the assignment to the Client concerning (1) hours worked by the Individual, (2) progress on the job, or (3) expenses incurred by the Individual in performing services for the Client. No reports (including reports of time worked or progress on the job) made by the Individual to the Client are provided by the Client to the Firm.

If the Individual ceases providing services for the Client prior to completion of the project or if the Individual's work product is otherwise unsatisfactory, the Client may seek damages from the Individual. However, in such circumstances, the Client may not seek damages from the Firm, and the Firm is not required to replace the Individual. The Firm may not terminate the services of the Individual while he or she is performing services for the Client and may not otherwise affect the relationship between the Client and the Individual. Neither the Individual nor the Client is prohibited for any period after termination of the Individual's services on this job from contracting directly with the other. For referring the Individual to the Client, the Firm receives a flat fee that is fixed prior to the Individual's commencement of services for the Client and is unrelated to the number of hours and quality of work performed by the Individual. The Individual is not paid by the Firm either directly or indirectly. No

payment made by the Client to the Individual reduces the amount of the fee that the Client is otherwise required to pay the Firm. The Individual is performing services that can be accomplished without the Individual's receiving direction or control as to hours, place of work, sequence, or details of work.

Situation 3

The Firm, a company engaged in furnishing client firms with technical personnel, is contacted by the Client, who is in need of the services of a drafter for a particular project, which is expected to last less than one year. The Firm recruits the Individual to perform the drafting services for the Client. The Individual performs substantially all of the services for the Client at the office of the Client, using materials and equipment of the Client. The services are performed under the supervision of employees of the Client. The Individual reports to the Client on a regular basis. The Individual is paid by the Firm based on the number of hours the Individual has worked for the Client, as reported to the Firm by the Client or as reported by the Individual and confirmed by the Client. The Firm has no obligation to pay the Individual if the Firm does not receive payment for the Individual's services from the Client. For recruiting the Individual for the Client, the Firm receives a flat fee that is fixed prior to the Individual's commencement of services for the Client and is unrelated to the number of hours and quality of work performed by the Individual. However, the Firm does receive a reasonable fee for performing the payroll function. The Firm may not direct the work of the Individual and has no responsibility for the work performed by the Individual. The Firm may not terminate the services of the Individual. The Client may terminate the services of the Individual without liability to either the Individual or the Firm. The Individual is permitted to work for another firm while performing services for the Client, but does in fact work for the Client on a substantially full-time basis.

LAW AND ANALYSIS

This ruling provides guidance concerning the factors that are used to determine whether an employment relationship exists between the Individual and the Firm for federal employment tax purposes and applies those factors to the given factual situations to determine whether the

Individual is an employee of the Firm for such purposes. The ruling does not reach any conclusions concerning whether an employment relationship for federal employment tax purposes exists between the Individual and the Client in any of the factual situations.

Analysis of the preceding three fact situations requires an examination of the common law rules for determining whether the Individual is an employee with respect to either the Firm or the Client, a determination of whether the Firm or the Client qualifies for employment tax relief under section 530(a) of the 1978 Act, and a determination of whether any such relief is denied the Firm under section 530(d) of the 1978 Act (added by section 1706 of the 1986 Act).

An individual is an employee for federal employment tax purposes if the individual has the status of an employee under the usual common law rules applicable in determining the employer-employee relationship. Guides for determining that status are found in the following three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d)-1(c); 31.3306(i)- 1; and 31.3401(c)- 1.

These sections provide that generally the relationship of employer and employee exists when the person or persons for whom the services are performed have the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so.

Conversely, these sections provide, in part, that individuals (such as physicians, lawyers, dentists, contractors, and subcontractors) who follow an independent trade, business, or profession, in which they offer their services to the public, generally are not employees.

Finally, if the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything

other than that of employer and employee is immaterial. Thus, if such a relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

As an aid to determining whether an individual is an employee under the common law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer- employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual 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 twenty factors are designed only as guides for determining whether an individual is an employee; special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are described below:

1. *Instructions.* A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the *right* to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66- 381, 1966-2 C.B. 449.

2. *Training.* Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.

3. *Integration.* Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be

subject to a certain amount of control by the owner of the business. See *United States v. Silk*, 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. *Services Rendered Personally*. If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.

5. *Hiring, Supervising, and Paying Assistants*. If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.

6. *Continuing Relationship*. A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk*.

7. *Set Hours of Work*. The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.

8. *Full Time Required*. If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.

9. *Doing Work on Employer's Premises*. If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done

off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. *Order or Sequence Set*. If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.

11. *Oral or Written Reports*. A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.

12. *Payment by Hour, Week, Month*. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.

13. *Payment of Business and/or Traveling Expenses*. If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's

business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.

14. *Furnishing of Tools and Materials.* The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.

15. *Significant Investment.* If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. *Realization of Profit or Loss.* A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. *Working for More Than One Firm at a Time.* If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. *Making Service Available to General Public.* The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. *Right to Discharge.* The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.

20. *Right to Terminate.* If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.

Rev. Rul. 75-41 considers the employment tax status of individuals performing services for a physician's professional service corporation. The corporation is in the business of providing a variety of services to professional people and firms (subscribers), including the services of secretaries, nurses, dental hygienists, and other similarly trained personnel. The individuals who are to perform the services are recruited by the corporation, paid by the corporation, assigned to jobs, and provided with employee benefits by the corporation. Individuals who enter into contracts with the corporation agree they will not contract directly with any subscriber to which they are assigned for at least three months after cessation of their contracts with the corporation. The corporation assigns the individual to the subscriber to work on the subscriber's premises with the subscriber's equipment. Subscribers have the right to require that an individual furnished by the corporation cease providing services to them, and they have the further right to have such individual replaced by the corporation within a reasonable period of time, but the subscribers have no right to affect the contract between the individual and the corporation. The corporation retains the right to discharge the individuals at any time. Rev. Rul. 75-41 concludes that the individuals are

employees of the corporation for federal employment tax purposes.

Rev. Rul. 70-309 considers the employment tax status of certain individuals who perform services as oil well pumpers for a corporation under contracts that characterize such individuals as independent contractors. Even though the pumpers perform their services away from the headquarters of the corporation and are not given day-to-day directions and instructions, the ruling concludes that the pumpers are employees of the corporation because the pumpers perform their services pursuant to an arrangement that gives the corporation the right to exercise whatever control is necessary to assure proper performance of the services; the pumpers' services are both necessary and incident to the business conducted by the corporation; and the pumpers are not engaged in an independent enterprise in which they assume the usual business risks, but rather work in the course of the corporation's trade or business. See also Rev. Rul. 70-630, 1970-2 C.B. 229, which considers the employment tax status of salesclerks furnished by an employee service company to a retail store to perform temporary services for the store.

Section 530(a) of the 1978 Act, as amended by section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, 1982-2 C.B. 462, 536, provides, for purposes of the employment taxes under subtitle C of the Code, that if a taxpayer did not treat an individual as an employee for any period, then the individual shall be deemed not to be an employee, unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period after December 31, 1978, this relief applies only if both of the following consistency rules are satisfied: (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee ("reporting consistency rule"), and (2) the taxpayer (and any predecessor) has not treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for periods beginning after December 31, 1977 ("substantive consistency rule").

The determination of whether any individual who is treated as an employee holds a position substantially similar to the position held by an individual whom the taxpayer would otherwise be permitted to treat as other than an employee for employment tax purposes under section 530(a) of the 1978 Act requires an examination of all the facts and circumstances, including particularly the activities and functions performed by the individuals. Differences in the positions held by the respective individuals that result from the taxpayer's treatment of one individual as an employee and the other individual as other than an employee (for example, that the former individual is a participant in the taxpayer's qualified pension plan or health plan and the latter individual is not a participant in either) are to be disregarded in determining whether the individuals hold substantially similar positions.

Section 1706(a) of the 1986 Act added to section 530 of the 1978 Act a new subsection (d), which provides an exception with respect to the treatment of certain workers. Section 530(d) provides that section 530 shall 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. Section 530(d) of the 1978 Act does not affect the determination of whether such workers are employees under the common law rules. Rather, it merely eliminates the employment tax relief under section 530(a) of the 1978 Act that would otherwise be available to a taxpayer with respect to those workers who are determined to be employees of the taxpayer under the usual common law rules. Section 530(d) applies to remuneration paid and services rendered after December 31, 1986.

The Conference Report on the 1986 Act discusses the effect of section 530(d) as follows:

The Senate amendment applies whether the services of [technical service workers] are provided by the firm to only one client during the year or to more than one client, and whether or not such individuals have been designated or treated by the technical services firm as independent contractors, sole proprietors, partners, or employees of a personal service

corporation controlled by such individual. The effect of the provision cannot be avoided by claims that such technical service personnel are employees of personal service corporations controlled by such personnel. For example, an engineer retained by a technical services firm to provide services to a manufacturer cannot avoid the effect of this provision by organizing a corporation that he or she controls and then claiming to provide services as an employee of that corporation.

. . . [T]he provision does not apply with respect to individuals who are classified, under the generally applicable common law standards, as employees of a business that is a client of the technical services firm.

2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-834 to 835 (1986).

Under the facts of Situation 1, the legal relationship is between the Firm and the Individual, and the Firm retains the right of control to insure that the services are performed in a satisfactory fashion. The fact that the Client may also exercise some degree of control over the Individual does not indicate that the individual is not an employee. Therefore, in Situation 1, the Individual is an employee of the Firm under the common law rules. The facts in Situation 1 involve an arrangement among the Individual, Firm, and Client, and the services provided by the Individual are technical services. Accordingly, the Firm is denied section 530 relief under section 530(d) of the 1978 Act (as added by section 1706 of the 1986 Act), and no relief is available with respect to any employment tax liability incurred in Situation 1.

The analysis would not differ if the facts of Situation 1 were changed to state that the Individual provided the technical services through a personal service corporation owned by the Individual.

In Situation 2, the Firm does not retain any right to control the performance of the services by the Individual and, thus, no employment relationship exists between the Individual and the Firm.

In Situation 3, the Firm does not control the performance of the services of the Individual, and the Firm has no right to affect the relationship between the Client and the Individual. Consequently, no employment relationship exists between the Firm and the Individual.

HOLDINGS

Situation 1. The Individual is an employee of the Firm under the common law rules. Relief under section 530 of the 1978 Act is not available to the Firm because of the provisions of section 530(d).

Situation 2. The Individual is not an employee of the Firm under the common law rules.

Situation 3. The Individual is not an employee of the Firm under the common law rules.

Because of the application of section 530(b) of the 1978 Act, no inference should be drawn with respect to whether the Individual in Situations 2 and 3 is an employee of the Client for federal employment tax purposes.