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THE ENTERTAINMENT INDUSTRY: THE OLD, THE NEW AND
THE CONTINUING UNCERTAINTY

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INDEPENDENT CONTRACTOR/EMPLOYEE CLASSIFICATION IN THE ENTERTAINMENT INDUSTRY: THE OLD, THE NEW AND THE CONTINUING UNCERTAINTY

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EMPLOYEE/INDEPENDENT CONTRACTOR CLASSIFICATION

A critical question faced by any business, including those in the entertainment industry, is whether the business is obligated to withhold and pay over employment taxes to the Internal Revenue Service on wages it pays to its workers. This determination hinges upon whether the workers are properly classified as employees or as independent contractors. The importance of this issue cannot be overstated. Business has faced daunting challenges in determining the proper classification of its workers. The tests historically applied by the Internal Revenue Service and the courts are inconsistent, ambiguous, applied unevenly, and dependent upon the weighing of numerous factors, some of which simply have no bearing in a particular case. Adding to the difficulty is competitive restraints. If the business treats its workers as employees while its competitors treat their workers as independent contractors, the business can suffer diminished sales and revenues due to competitive pricing needs. Despite this uncertainty in how the rules apply and the competitive realities faced by business, the Internal Revenue Service has relentlessly and unabashedly assessed employment taxes against such businesses on a retroactive basis, even in cases where proper classification is at best unclear. Frequently, this has caused businesses to suffer ruinous financial liabilities, forcing dissolutions.

In 1978, Congress attempted to provide some relief by enactment of Section 530 of the Revenue Act of 1978 (a provision which is not codified into the Internal Revenue Code). Section 530 prohibits the Internal Revenue Service from issuing regulations or revenue rulings pertaining to worker classification. It also pro-

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vides safe harbors for businesses that have a reasonable basis for treating certain workers as independent contractors and, if its requirements are satisfied, prohibits the Internal Revenue Service from reclassifying those workers as employees even if such workers otherwise meet the standards for employee classification. Initially, Section 530 was enacted for a limited period pending Congressional action to clarify the definition of employee. When Congressional action failed to materialize, Section 530 was indefinitely extended.

During the recession, the Internal Revenue Service's vigorous and zealous pursuit of employee classification and seeming disregard of public concerns about loss of jobs led to even greater criticism of its policies. The 1995 White House Conference on Small Business listed worker classification as the most significant issue facing small business today. In response to mounting public and Congressional pressure, the Service recently issued four new policies designed to add clarity, fairness and expediency to the resolution of the worker classification issue. Last summer, Congress amended Section 530 to expand its availability to taxpayers. This article will discuss the 20-factor test traditionally relied upon by the Service to make worker classification determinations, the differences in tax liability and compliance obligations that result from an employee or independent contractor classification, and the consequences of an adverse determination. This article will then summarize entertainment industry cases, private letter rulings, the newly issued guidelines for the television commercial production and professional video communications industries as part of the market segment specialization programs, the newly issued training materials used by the Internal Revenue Service to instruct field agents on determining proper worker classification, a new classification settlement program initiated by the Internal Revenue Service, recent expansion of the early referral program to transfer worker classification disputes more quickly to the appeals office of the Service, and significant revisions of Section 530 by The Small Business Job Protection Act of 1996. Finally, this article will summarize the potential impact of these new programs on worker classification determinations.

Consequences Of Employer Classification

A worker is classified as an employee or independent contractor for employment tax purposes under the "common law test" set out in Treas. Reg. § 31.3401(c)-1 (income tax withholding), Treas.

Reg. § 31.3121(d)-1 (FICA) and Treas. Reg. § 31.3306(i)-of the Federal Unemployment Tax Act ("FUTA"). This test generally provides that the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so. If the worker is classified as an employee, the following consequences flow:

FICA. The worker's wages are subject to tax under the Federal Insurance Contributions Act ("FICA"), which is imposed equally on both the employer and worker under I.R.C.¹ §§ 3102(a) and 3111. Currently, the FICA tax rate is equal to 7.65% for both employer and employee (for combined rate of 15.30%). For 1996, the social security portion of the FICA tax is 6.2% (12.4% combined worker and employer), and is imposed on a taxable wage base of up to \$62,700. The Medicare portion of the FICA tax is 1.45% (2.9% combined worker and employer), and is imposed on all taxable wages and without limitation.

FUTA. The employer is subject to tax under the Federal Unemployment Tax Act ("FUTA"), which is imposed at the rate of 6.2% on the first \$7,000 of wages paid to the worker (partially subject to credit for state withholding).²

Income Tax Withholding. The employer is required to withhold and pay over federal and state income taxes imposed on the worker on the wages paid by the employer.³

Qualified Plans. The worker is not entitled to maintain his or her own KEOGH or corporate qualified pension plan.⁴ The worker may be entitled to maintain an Individual Retirement Account ("IRA") and deduct up to \$2,000 (\$4,000 for spousal IRA effective January 1, 1997) per year.⁵ If the worker or the worker's spouse is an active participant in a qualified retirement plan, the deductible IRA amount is phased out to the extent the worker's

1. Unless otherwise indicated, all references to the Internal Revenue Code or the I.R.C. shall refer to the Internal Revenue Code of 1986.

2. I.R.C. § 3301 (West 1996).

3. I.R.C. § 3401 (West 1996); see Rev. Rul. 92-106, 1992-2 C.B. 258, for tax and withholding obligations imposed on U.S. and foreign employees for U.S. citizens and residents working abroad.

4. I.R.C. § 401 (West 1996).

5. I.R.C. §§ 219, 408 (West 1996).

adjusted gross income exceeds \$10,000. The deduction is totally phased out for single workers whose adjusted gross income equals or exceeds \$35,000, for married taxpayers filing jointly whose adjusted gross income equals or exceeds \$50,000, and for married workers filing separate returns whose adjusted gross income equals or exceeds \$10,000 or more. The employer generally is required to include the worker in its pension plans and other fringe benefit plans available to employees.

State Taxes. The employer may be required to withhold and pay state disability taxes from employee wages, make contributions to a state unemployment fund, and withhold and pay over state income tax from the worker's wages.

Workers' Compensation. The employer may be required to include the worker in its workers' compensation insurance program. In the case of injury, workers' compensation coverage may produce a lower award than that obtainable under general tort law principles that would apply if the worker was instead classified as an independent contractor.

Itemized Deductions/Alternative Minimum Tax. The worker will not be entitled to deduct "itemized miscellaneous deductions" to the extent they do not exceed 2% of the worker's adjusted gross income.⁶ Such expenses include travel, transportation and entertainment expenses, and union or professional dues.⁷ Miscellaneous itemized deductions are not deductible at all for purposes of computing alternative minimum tax⁸ and substantial alternative minimum tax may result in the case of some employees, for example, entertainers who pay large agent fees, business management fees and the like.

An employee is also more adversely affected than an independent contractor by the provisions of I.R.C. §§ 68 and 151(d). Section 68 reduces the amount of certain itemized deductions that an individual may deduct by the lesser of (i) 3% of excess of the taxpayer's adjusted gross income over \$117,950 (\$58,975 in the case of a married taxpayer filing separately), or (ii) 80% of itemized deductions. Section 151(d) phases out an individual's personal exemptions once the taxpayer's adjusted gross income reaches a prescribed threshold (\$117,950 for single taxpayers, \$176,950 for married taxpayer filing jointly, \$147,450 for married taxpayer filing as head of household, and \$88,475 for

6. I.R.C. § 67 (West 1996).

7. Treas. Reg. § 1.67-1T(a)(1)(i) (1988).

8. I.R.C. § 56(b)(1)(A) (West 1996).

married taxpayer filing separately). The limitation in section 68 and the phase-out in section 151(d) are based on a taxpayer's "adjusted gross income," which will generally be greater for an employee who cannot deduct certain business expenses above the line like an independent contractor can.

Consequences of Independent Contractor Classification

If the worker is deemed to be an independent contractor, the following consequences flow:

SECA. The worker must pay tax under the Self-Employment Contributions Act ("SECA") on self-employment income.⁹ SECA is now equal to the combined FICA rate, which is imposed for 1996 on employers and employees for a rate of 12.4% on a taxable wage base of up to \$62,700 and 2.9% on all taxable wages without limitation. The worker may deduct one-half of SECA tax paid.¹⁰

Estimated Income Tax Payments. The worker is responsible for making quarterly estimated federal and state income tax payments.

Qualified Plan. The worker is entitled to maintain his or her own qualified KEOGH plan¹¹, or if the worker is incorporated, a qualified corporate pension plan. This allows the worker to determine how much he or she will contribute to a qualified pension plan, subject to applicable limitations, in contrast to an employee who is subject to the employer's decision. In addition, the amount of the contribution may not be dependent upon the amount that is contributed for other workers as is the case in a plan sponsored by an employer for the benefit of its employees.

Loan-Out Corporation. If a loan-out corporation is utilized, the worker is treated as an employee of the corporation and the corporation is required to pay employment taxes and withhold taxes as described above for employees.¹²

Motivations To Classify Workers As Independent Contractors

There are a number of reasons why both employers and workers may prefer that their relationship be structured as an independent contractor relationship. Hiring independent contractors enables the employer to match labor to its business needs and not be encumbered by large, permanent payrolls, simplify

9. I.R.C. § 1401 (West 1996).

10. I.R.C. § 1401(c) (West 1996).

11. Treas. Reg. § 1.401-10 (1963).

12. See discussion *infra* p.15.

accounting burdens, and avoid union and collective bargaining agreements. Hiring independent contractors further serves to reduce the employers workers' compensation insurance premiums, but may expose the employer to greater liability under general tort liability in the event of injury. From the worker's perspective, he or she may be able to earn greater income working as an independent contractor for multiple employers since his or her compensation is not reduced by the cost of employee benefit plans. In addition, the independent contractor may have greater flexibility in timing tax payments.

TRADITIONAL IRS TEST FOR DETERMINING CLASSIFICATION

Rev. Rul. 87-41

The Internal Revenue Service is not bound by the parties' characterization of their relationship and will independently evaluate whether the worker is an employee or an independent contractor. In Rev. Rul. 87-41,¹³ the Internal Revenue Service set forth 20 factors it traditionally reviewed in making this determination. These factors are:

1. *Instructions or Degree of Control.* An employer generally exercises a much greater degree of supervision and control over the details of the work being done (i.e., to instruct when, where, and how the work is to be done) by employees than by independent contractors.
2. *Furnishing of Training.* An employer generally does not provide any training to independent contractors or to employees of an independent contractor.
3. *Integration.* An independent contractor generally engages in projects that are not a part of the day-to-day operations of the company.
4. *Services Rendered Personally; Right to Delegate Work.* An employee is generally required to render the requested services personally, whereas an independent contractor has the right to bring in whomever he or she pleases to accomplish the purpose of the contract.
5. *Right to Hire, Supervise, Pay and Fire Assistants.* An independent contractor agrees to provide the labor necessary to accomplish the purpose of the contract and has the right to hire, supervise, pay and fire assistants. In contrast, if the person for whom the services are performed has these rights, an employee relationship is indicated.

13. Rev. Rul. 87-41, 1987-1 C.B. 296.

6. *Continuing Relationship.* An independent contractor is generally hired for a specified time period whereas an employee is generally hired for an indefinite period of time.
7. *Control Over Hours of Work.* The employer's right to set the hours worked indicates employee status; independent contractors are generally allowed to set own hours, subject to reasonable requests from the employer, for example, that work not be performed during specified hours.
8. *Independent Trade; Full Time Work.* Where a worker must work full time for the employer for whom services are provided, such person has greater control over the worker's work. An independent contractor is generally not required to work full-time or exclusively for the employer and may work for multiple employers simultaneously.
9. *Place of Work.* Working on the employer's premises indicates employer control and employee status.
10. *Sequence of Work.* An employer does not direct an independent contractor as to the sequence in which the work should be performed; the employer directs only the outcome of the work to be obtained and not the manner in which it is obtained.
11. *Reports Required.* An independent contractor is generally not required to submit regular reports or attend regular company meetings.
12. *Payment by Hour, Week or Month.* An independent contractor is generally paid by the job whereas an employee is generally paid by the hour, week or month.
13. *Payment of Business and/or Travel Expenses.* A worker whose business and/or traveling expenses is reimbursed by the person for whom services are performed is ordinarily an employee, whereas an independent contractor typically bears his or her own expenses.
14. *Furnishing of Tools.* An independent contractor generally provides his or her own tools, whereas an employee is provided tools by the employer.
15. *Investment in Facilities.* Independent contractor status is indicated where the worker has made a significant investment in facilities used in performing services; Lack of an investment in facilities indicates dependence upon the person for whom services are provided and employee status.
16. *Profit and Loss.* An independent contractor generally bears the risk of making a profit or loss on a job, for