Field Service Advice Memorandum, Withholding of tax on wages: Income: FICA: FUTA: Nurses: Healthcare workers: Employee v. independent contractor: Social Security Act: Safe harbor provisions, applicability of., FSA 0695, Internal Revenue Service, (Aug. 24, 1993)

FSA 0695
FSA 1993-0824-1 (CCH)

Code Sec. 3121, 3401

Internal Revenue Service

memorandum

TL-N-*****

EBEO:Br2:DRMorley

date: AUG 24 1993

to: District Counsel - *****

from: Assistant Chief Counsel

(Employee Benefits and Exempt Organizations)

subject: Request for Field Service Advice

Re: *****

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYERS INVOLVED; AND ITS USE WITHIN THE IRS SHOULD BY LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

This memorandum is in response to your request for advice of January 14, 1993, on whether certain workers were employees or independent contractors, whether the workers were subject to an agreement under section 218 of the Social Security Act, and whether section 530 of the Revenue Act of 1978 provides relief. As we understand this case, the years in issue are ***** through ***** and two district parties are involved: a nurse registry and a hospital corporation. The nurse registry workers were primarily nurses and the hospital corporation workers performed a variety of services, including home nursing care.

Issues

1. Whether the workers were employees for federal tax purposes, and, if so, which organization was the employer?

2. Whether the workers were covered by an agreement under section 218 of the Social Security Act?

3. If any of the workers were employees, whether section 530 of the Revenue Act of 1978 terminates the taxpayers, liability for employment taxes?

Facts

The ***** Appeals Office has requested assistance from the **** District Counsel concerning a case before it.

This case involves two taxpayers: The ***** ("******") and ***** ("******"). At issue in this case are workers who performed services directly for ***** and workers who performed services for ***** through the ***** nurse registry from ***** through *****.

***** is an instrumentality of the ***** and operates municipal hospitals, long-term-care facilities, neighborhood health facilities, and clinics. Five primary categories of workers perform services directly for *****: (1) home health nurses, (2) student nurses, (3) therapists, (4) chart coders, and (5) instructors and counsellors.

***** is a wholly-owned subsidiary of ***** and maintains a nurses' registry. ***** furnishes per diem nurses to the municipal hospitals and health care facilities operated by ***** percent of the individuals performing services for ***** are registered nurses.

On *****, the ***** and the Secretary of Health, Education, and Welfare entered into an agreement under section 218 of the Social Security Act: On ***** that agreement was modified to include services performed for *****. The agreement excludes ***** assets. ***** that these provisions exclude some of their workers from coverage.

Law

For purposes of the Federal Insurance Contributions Act (FICA) sections 3101 and 3111 of the Internal Revenue Code impose an excise tax on the wages paid by employers to employees with respect to employment. Section 3102 of the Code requires employers to withhold and deposit the employee's portion of the FICA tax. Section 3402 of the Code similarly requires employers to withhold income tax on wages paid to employees with respect to employment.

The FICA tax comprises two separate taxes. Section 3101(a) and 3111(a) impose Old-Age, Survivor's and Disability Insurance (OASDI) taxes and section 3101(b) and 3111(b) impose Hospital Insurance (HI) taxes.

Section 3121(d)(4) of the Code provides that the term "employee" means any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act. The determination of whether an individual is an employee under this section is made by the State Social Security Administrator and the Social Security Administration (SSA). Section 3121(b)(7)(E) of the Code similarly includes in the definition of "employment" service included under a section 218 agreement.

If an individual who performs services for a state, political subdivision, or instrumentality thereof is not covered by a section 218 agreement, then section 3121(d)(2) of the Code applies for purposes of determining whether that individual is an employee.

Section 3121(d)(2) provides that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The question of whether an individual is an employee under the common law rules is one of fact to be determined upon consideration of the facts and the application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

Section 31.3121(d)-1(c)(2) of the regulations provides that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what must be done but as to how it must 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 he or she has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is the employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he or she is an independent contractor.

Section 31.3121(d)-1(a)(3) of the regulations provides that 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 the relationship exists, it is of no consequence that the employee is designated as partner, coadventurer, agent, independent contractor, or the like.

Section 3121(b)(7) of the Code excludes from “employment” service performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing which is wholly owned thereby. [1]

Subparagraph (A) of Code section 3121(u)(2) provides that, for purposes of the HI tax, sections 3101(b) and 3111(b) are generally applied to state and local government employees and employees of instrumentalities thereof without regard to the general exclusion in paragraph (7) of section 3121(b). Under Code section 3121(u)(2)(B)(i), service included under a section 218 agreement shall not be treated as employment by reason of subparagraph (A) for HI tax purposes. Therefore, when section 3121(u) was enacted, wages paid to individuals covered by a section 218 agreement were not subject to HI taxes.

Section 9002 of the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, subsequently added subparagraph (E) to section 3121(b)(7) of the Code to provide that payments for coverage under section 218 agreements are FICA taxes. In particular, section 3121(b)(7)(E) was added to the Code to provide that “employment” includes service included under an agreement entered into pursuant to section 218 of the Social Security Act. This subparagraph (E) stands alone and applies regardless of the general exclusion in paragraph (7) of section 3121(b). Under section 3121(u)(2), service covered by a section 218 is agreement is not treated as employment by reason of subparagraph (A), but the HI tax is still applied with regard to subparagraph (E) of section 3121(b)(7). Accordingly, now that payments for individuals covered by a section 218 agreement are FICA taxes under section 3121(b)(7)(E), service included under a section 218 agreement is treated as employment and is, for the period in issue, subject to HI tax.

Section 3121(u)(2)(C) of the Code provides a continuing employment exception to section 3121(u)(2)(A). If an individual was performing service for his or her employer before April 1, 198.6, was a bona fide employee on March 31, 1986, had not entered into employment for purposes of meeting the requirements of this subparagraph, and the employment relationship with that employer has not been terminated after March 31, 1986, that individual will not be subject to HI tax under sections 3101(b) and 3111(b). This exception does not apply, however, if the individual is covered by a section 218 agreement.

Accordingly, employees of state and local governments and instrumentalities thereof are subject to the HI tax unless they are not covered by a section 218 agreement and fall within the continuing employment exception of section 3121(u)(2)(C).

Section 3121(b)(13) of the Code excludes from “employment” service performed by a student nurse in the employ of a hospital or nurses, training school by an individual who is enrolled and is regularly attending classes in a nurses’ training school chartered or approved pursuant to state law.

Section 530(a)(1) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, provides that, for employment tax purposes, an individual will be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating the individual as an employee.

Section 530(a)(2) provides, in pertinent part, that, for purposes of paragraph (1), a taxpayer will in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer’s treatment of the individual for that period was in reasonable reliance on any of the following:

(A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(B) a past Internal Revenue Service 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 this individual; or

(C) long-standing recognized practice of a significant segment of the industry in which the individual was engaged.

Section 530(a)(3) provides that paragraph (1) shall not apply with respect to the treatment of any Individual for employment tax purposes if the taxpayer (or a predecessor) has treated any individual holding a substantially

similar position as an employee-for purposes of the employment taxes for any period beginning after December 31, 1977 (“substantive consistency”).

Section 530 terminates an employer’s liability for employment taxes under Subtitle C, which includes FICA and income tax withholding, and any interest or penalties attributable to the liability for employment taxes. Section 530 applies only after a worker has been classified as an employee.

Analysis

First, to determine liability for employment taxes, it must be ascertained whether the workers are employees and of whom. Second, it must be determined whether an exception applies. ***** was an instrumentality for purposes of section 3121(b)(7), and, as such, its employees were not subject to OASDI taxes under sections 3101(a) and 3111(a) unless they were covered by a section 218 agreement. All of ***** employees were subject to HI taxes unless the employees were not covered by a 218 agreement and the continuing employment exception of section 3121(u)(2)(C) applied to individual employees.

As a wholly-owned subsidiary of ***** is likely an instrumentality for purposes of section 3121(b)(7). Rev. Rul. 57-128, 1957-1 C.B. 311, sets forth six factors used to determine whether an organization is an instrumentality of a state and should be consulted to ensure that ***** is indeed an instrumentality. If it is not, section 3121(b)(7) of the Code does not apply and ***** is not covered under the 218 agreement. For purposes of the remainder of this memorandum, we assume that ***** is an instrumentality of ***** a political subdivision of the *****. Thus, if employees of ***** are not subject to OASDI taxes but were subject to HI taxes unless the continuing employment exception of section 3121(u)(2)(C) applied.

Third, if workers’ wages are subject to employment taxes, it must be determined whether the employer is entitled to relief from these taxes under section 530 of the Revenue Act of 1978. It is the position of the National Office that state or local employers of employees who are covered by a section 218 agreement are not entitled to section 530 relief with respect to those workers. However, employers of employees not coveted by a section 218 agreement are entitled to section 530 relief with respect to those workers if the requirements of that section are met. [2]

Issue 1: Whether the workers were employees or independent contractors under the common law?

In determining whether an individual is an employee under the. common raw rules, twenty factors 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. See Rev. Rul. 87-41, 1987-1 C.B. 296.

Consideration must also be given to such factors as the continuity of the relationship and whether or not the individual’s services are an integral part of the business of the employer as distinguished from an independent trade or business of the individual in which he or she assumes the risks of realizing a profit or suffering a loss. See United States v. Silk, 331 U.S. 704 (1947), 1947-2 C.B. 167; Bartels v. Birmingham, 332 U.S. 126 (1947), 1947-2 C.B. 174.

The regulations list four factors: (1) right to control, (2) right to discharge, (3) furnishing tools, and (4) furnishing a place to work. The Supreme Court in Silk listed six factors: (1) degree of control, (2) opportunity for profit or loss, (3) investment in facilities, (4) permanency of relationship, (5) skill required, and (6) integration of services into the employer’s regular business.

a. *** Per Diem Nurses**

With respect to the ***** nurses, the issue is not only whether the nurses were employees, but who was the employer. We believe that, based on all the facts and circumstances presented to us, the nurses who obtained work through the ***** nurse registry were employees of *****. Following is an analysis of how the common law applies to them.

1. Instructions: The nurses were given instructions at the beginning of each shift. ***** directed the nurses to report to particular hospitals and informed them how many hours they were to work.

2. Training: Registered nurses have, by virtue of their nursing degree, completed the training necessary for their profession. The importance of this factor is minimized, because their training has been completed. Nevertheless, ***** established a continuing professional education program for its nurses.

3. Integration: The Taxpayer's business is providing nursing services to hospitals. Accordingly, the success or failure of ***** is wholly dependent on the performance of its nurses. That ***** would find it necessary to establish a continuing professional education program for its nurses is evidence of ***** need to control the quality of its nurses. It is clear that ***** business depended upon whether the nurses performed and kept performing services. When a company's success or failure depends on whether its workers perform their work in a timely and skillful manner, the company must ensure the diligence of its workers, another indication of control. See Morish v. United States, 555 F.2d 794 (Ct. Cl. 1977).

4. Services Rendered Personally: ***** approved the credentials of its nurses before permitting them to perform services on its behalf. ***** required applicants to complete detailed pre-employment forms so it could determine whether its nurses would represent the company appropriately.

5. Assistants: ***** per diem nurses did not have the authority to hire, supervise, or pay assistants.

6. Continuing Relationship: A large proportion of ***** nurses had been performing services through ***** for an extended period of time.

7. Set Hours: ***** argues that its nurses were free to select their assignments and, thus, were permitted to select their hours. Once the assignment had been selected, however, the nurse was required to work the number of hours specified for that assignment. The nurses had no choice once they had selected an assignment.

8. Full Time: The nurses were not required to work full time, and, in fact; many also worked directly for *****.

9. Work on Employer's Premises: In some occupations, the services can only be performed away from the business premises of the employer. The nurses obviously could not care for patients in ***** offices. Accordingly, this factor is not significant.

10. Order or Sequence Set: A nurse is a trained professional who is expected to know how and in what order to perform her duties. Accordingly, the importance of this factor is minimized.

11. Reports: The nurses were required to report on treatment provided and patient progress. The hospital required the nurses to document patients' treatment and progress on charts. ***** established a ***** to monitor the performance of its nurses, another indication of control.

12. Payment by Hour, Week, etc.: The nurses were paid bi-weekly, based on the number of hours worked. ***** was reimbursed monthly by the hospitals. While ***** attempts to characterize the means of payment as "by the job," it is clear that the nurses were compensated based on time spent rather than on the completion of jobs. Furthermore, the nurses were paid without regard to whether ***** was paid.

13. Payment of Expenses: ***** and the hospitals paid most of the business expenses of the nurses. The nurses were, however, required to provide their own malpractice insurance.

14. Furnishing Tools & Materials: The nurses furnished only stethoscopes and uniforms. All other equipment was provided by the hospitals. Certain skilled workers, such as carpenters, auto mechanics, and barbers customarily furnish their own small tools for their trade. This practice does not indicate a lack of control by the firm over the worker.

15. Investment in Facilities: The nurses had no investment in the business of ***** or the hospitals or in the buildings or other facilities used by the nurses, ***** or the hospitals.

16. Profit or Loss: Because the nurses had no investment, they bore no risk of loss other than that ordinarily assumed by employees. The nurses expended no money or effort to generate work. ***** generated all of the

business and paid all advertising expenses. The nurses did not hire assistants or pay for their own offices or equipment. The only way the nurses could have made more money was to work more hours. Managerial skill and know-how played no role in their ability to increase their earnings.

17. Working for More than One Firm: Many of the ***** nurses also worked as employees of *****. It is possible, however, for a person to work for a number individuals or firms and be an employee for one or all of them.

18. Services Available to General Public: None of the nurses offered services to the general public. Any advertising was done by ***** not the nurses. The nurses did not maintain business listings, have their own offices, or act in a managerial capacity.

19. Right to Discharge: ***** could discharge the nurses at any time without incurring any liability. If a nurse's performance was unsatisfactory, that nurse would not be referred again.

20. Right to Terminate: The nurses were free to quit at any time. They were under no contractual obligation to perform a given amount of services and, thus, could not incur liability for terminating their services.

In summary, a thorough analysis of the twenty common law factors strongly indicates that the nurses were employees of *****. While the hospitals exerted a measure of control, the ultimate rights of control lay with *****.

Before creating *****, ***** treated its nurses as employees. During the years in question, the ***** nurses were not performing duties that were significantly different from those performed by ***** nurses prior to the creation of *****. ***** required its nurses to perform their services up to ***** standards and to complete CPE courses. It is clear that the nurses were not in business for themselves but were, in fact, integrated into the business of ***** and *****. It is also clear that ***** controlled the nurse through its authority to refer or not refer, to screen nurses' educational and employment history, and to monitor the performance of the nurses through the *****.

The taxpayers rely on the fact that the most important asset of trained individuals, such as nurses, is their education, which is in effect, an asset the nurses bring to the job. Under this rationale, virtually no professionals could be employees. James v. Commissioner, 25 T.C. 1296 (1956), held that a doctor was an employee of a hospital even though the hospital's control over the doctor's work was "general". The court stated that the methods by which professional men work are prescribed by the techniques and standards of their professions. No layman should dictate to a lawyer how to try a case or to a doctor how to diagnose a disease. Therefore, the control of an employer over the manner in which professional employees shall conduct the duties of their positions must necessarily be more tenuous and general than the control over nonprofessional employees.

In re Critical Care Support Services, Inc., 138 B.R. 378 (Bkrtcy. E.D.N.Y. 1992), held that a nurse who performed services for hospitals through a referral agency were employees of the agency. The court emphasized that the agency "screens the nurses prior to its sending any nurse to a hospital, so that the [agency] is assured the nurse possesses the requisite license, skill, and malpractice insurance. If the [agency] found that the nurse did not have the appropriate license, skill, and malpractice insurance, the [agency] would not place this nurse at a requesting hospital." Id. at 379.

Although the agency did not supervise the nurses in their daily performance at the hospital, the court found that the agency retained the right to control them.

[S]ince we are dealing with professional critical care nurses, who are carefully screened by the [agency] as to their qualification, there is no need for [the agency] to actually control their every movement once the nurses arrive at the hospital. The [agency] does, however, retain the right to control, which is reflected in the [agency's] right not to send a particular nurse to a particular hospital, or to assign that nurse to several different duties at the same hospital, or to withhold assignments for any period of time. The [agency] has the right to assign the nurse to a particular duty specifying the time and place of the work. The [agency] pays the nurse directly regardless of whether it receives payment from the hospital. The nurses have no right to obtain substitutes or to hire anyone else in their stead. If a nurse is unable to fulfill her duties, the [agency] is the one who may provide another qualified nurse.

Id. at 382. We find these facts virtually indistinguishable from those present in this case.

Because the twenty common law factors are not always readily applicable to professional workers, Rev. Rul. 61-196, 1961-2 C.B. 155, isolates four factors that are particularly applicable to nurses. The pertinent factors that must be considered are (1) the type and nature of the services performed. (2) the control exercised and by whom, (3) whether the individual is a licensed nurse, and (4) evidence establishing whether or not the services were performed in the conduct of an independent trade, business, or profession. These factors were emphasized because the high degree of skill required by a professional and the methods by which he or she works make it difficult for the person or firm for which the services are performed to control the details in the performance of services. Rev. Rul. 61-196 held that registered nurses and licensed practical nurses can be either employees or independent contractors, depending upon the nature of the working relationship. This is the case even though the nurses are licensed professionals.

The taxpayer contends that Rev. Rul. 61-196 supports its position that the nurses were independent contractors and that the ruling's reasoning preempts the twenty common law factor analysis in Rev. Rul. 87-41. We believe the taxpayer is wrong on both counts.

First, we believe the ***** nurses were more like the nurses described as employees in Rev. Rul. 61-196. Citing Rev. Rul. 61-195, Rev. Rul. 75-101, 1975-1 C.B. 318, concluded that licensed practical nurses who receive assignments through a nurse registry are employees of the registry. We believe the facts in that ruling are sufficiently similar to those in the present case to warrant classifying the ***** nurses as employees. The nurses in the ruling were subject to approval based on their training and experience. The firm issued instructions and monitored the performance of its nurse. The firm also had the right to terminate its nurses for cause. Those factors led to the conclusion that the nurses were not engaged in an independent enterprise in which they assumed the risk of profit or loss. Because they are skilled workers, nurses do not require constant supervision.

Second, the controlling law is section 3121(d)(2) of the Code, which states that a worker's status is determined under the common law. Rev. Rul. 87-41 represents the Service's compilation of the factors under the common law. Rev. Rul. 61-196 was issued prior to Rev. Rul. 87-41, so 87-41 clearly represents the Service's most current thinking on the status of the common law. Furthermore, Rev. Rul. 61-196 merely sets forth the most important factors when nurses are involved. Those factors, however, do not represent an exclusive list.

Accordingly, we conclude that the ***** nurses were employees of *****. The wages of those nurses who did not qualify for the continuing employment exception of Code section 3121(u)(2)(C) were subject to HI taxes under sections 3101(b) and 3111(b) of the Code. ***** was also liable for income tax withholding under section 3402 of the Code. Whether there was liability for the OASDI taxes depends on whether services performed for ***** were covered by a section 218 agreement. That issue will be discussed below.

b. *** Workers**

The facts in the file with respect to the ***** workers are not as well-developed as those relating to the ***** nurses. More facts relating to the twenty common law factors be useful to bolster the conclusion that these workers were employees.

(i) Home Health Nurses

Several factors indicate the home health nurses were independent contractors. They were paid per visit rather than by time spent, they were permitted to work for others, and they were not reimbursed for their expenses. On the other hand, they were apparently required to report to *****, were provided the necessary tools and equipment, and had no investment or potential for profit or loss. The nurses were clearly not in business for themselves. The nurses were required to perform their services personally and could be dismissed or they could terminate their services at any time without incurring liability. Thus, on balance, the nurses were apparently employees of *****

(ii) Student Nurses

It seems clear that the student nurses were common law employees of *****. The issue is whether those services were excluded from employment.

Section 3121(b)(13) of the Code excludes from employment services performed by a student nurse in the employ of a hospital. The Service's position is that three requirements must be met for a student nurse to qualify for the exclusion: (1) the employment must be substantially less than full time, (2) the total earnings must be nominal, and (3) the only services performed by the student nurse for the employer are incidental parts of the student nurse's training toward a degree that will qualify him or her to practice as a nurse or in a specialized area of nursing. Rev. Rul. 85-74, 1985-1 C.B. 331. See LTR 8942005 for a full discussion of these factors. The Service's position has recently been upheld in Johnson City Medical Center Hospital v. United States, 783 F. Supp. 1048 (E.D. Tenn. 1992), aff'd, No. 92-5499, 1993 U. S. App. LEXIS 18585 (6th Cir. July 23, 1993). In addition, the nurses' training school must be chartered or approved pursuant to state law. Although the facts presented do not specifically relate to these factors, we believe the nurses enrolled in the School of ***** likely did not satisfy these requirements. The facts and circumstances should be analyzed further to determine whether the other student nurses satisfied these requirements.

(iii) Therapists, Chart Coders, Instructors, and Counsellors

Given the amount of information supplied with respect to these workers, we do not believe we can provide an opinion on their employment status. The common law factors should be applied to each worker to determine whether he or she was an employee of *****.

Issue 2: Whether the workers were subject to an agreement under section 218 of the Social Security Act?

If a worker is covered by a section 218 agreement, he or she is an employee under section 3121(d)(4), is engaged in employment under section 3121(b)(7)(E), and wages paid to the worker are, therefore, subject to FICA taxes.

The determination of whether an individual is covered by a section 218 agreement and whether an individual is an employee under section 3121(d)(4) is within the purview of the State Social Security Administrator. We had a preliminary discussion with ***** Social Security Administrator, who held the opinion that the ***** workers were likely covered by the section 218 agreement. ***** contends that some of the nurses were excluded from coverage as student nurses. According to ***** the definition of student nurse in the 218 agreement is similar to the definition under section 3121(b)(13) of the Code. Furthermore, under the 218 agreement, registered nurses pursuing an advanced nursing degree in anesthesia are not excluded from coverage. He stated that individuals who have already received a nursing degree and are pursuing an advanced degree do not qualify as student nurses.

We also tentatively conclude that ***** is not covered by the 218 agreement because coverage was apparently extended to the instrumentalities of *****. Additional facts should be submitted to ***** office for a more thorough determination of this issue.

Issue 3: If the workers were employees, does section 530 of the Revenue Act of 1978 terminate the employer's liability for employment taxes?

FICA Taxes

If the ***** Social Security Administrator and SSA determine that the workers were covered by a section 218 agreement and were employees under section 3121(d)(4), it is our opinion that relief would not be available under section 530 with respect to FICA taxes.

For purposes of section 530, section 530(c)(1) defines employment tax "as any tax imposed by Subtitle C of the Internal Revenue Code." Thus, the FICA taxes at issue here are employment taxes for section 530 purposes. As a result of the legislative changes made in 1986, service covered by an agreement entered into under section 218 was included within the definition of employment for FICA tax purposes.

The legislative history in connection with section 530 implies that section 530 was directed at reclassification controversies between the Internal Revenue Service and taxpayers and raises the question whether reclassification controversies between taxpayers and Social Security Administrators under section 218 agreements should be covered. House Report 95-1748, 95th Cong., 2d Sess. (1978), at page 4, states that:

The bill provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees under interpretations of the common law...

The bill provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassification of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees.

If an employee is covered under a section 218 agreement, the determination that the worker is an employee and a member of a coverage group has been made by the State Social Security Administrator, with the concurrence of the Social Security Administration. Although the question of the employment tax status of the worker may have been initiated by the Service and payment of the employment tax is made to the Service, the final jurisdiction over the employee-independent contractor issue does not rest with the Service if the decision has been made that the worker is covered under a section 218 agreement. Although the legislative history was written when contributions under section 218 agreements were not treated as FICA taxes, it demonstrates the scope of Congressional concern.

When section 530 was enacted, state and local employers were not subject to taxation under either the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA) Section 3121(b)(7) of the Internal Revenue Code excluded services performed for these entities from "employment." For FUTA purposes, section 3306(c)(7) excluded (and continues to exclude) from "employment" services performed in the employ of a state, or any political subdivision thereof.

Although services performed for state and local governments were excluded from the definition of "employment" in the FICA by section 3121(b)(7) of the Code, social security coverage for those services could be obtained through a section 218 agreement. Social security contributions made with respect to the agreements were not FICA taxes. The regulations relating to the payments and reports of these social security contributions were under the jurisdiction of the SSA. When section 530 was enacted, 42 U.S.C. 418(e)(1)(A) provided that section 218 agreements must provide "that the State will pay to the Secretary of the Treasury, at such time or times as the Secretary of Health, Education, and Welfare may by regulations prescribe, amounts equivalent to the sum of the taxes which would be imposed by sections 1400 and 1410 of the Internal Revenue Code of 1939 (the predecessors of sections 3101 and 3111 of the 1986 Code), if the services of employees covered by the agreement constituted employment as defined in section 1426 of the Internal Revenue Code of 1939 [section 3121]." Thus, when states signed on to social security coverage, they contractually agreed to pay the equivalent of FICA taxes ("social security contributions") with respect to employees within coverage groups.

As a result of this contractual relationship with the state, the state had primary liability for social security contributions rather than the employing entity. If SSA established an underpayment of social security contributions under a section 218 agreement, the state was the party liable under the contract, not the governmental entity employing the individual. The Administrator of SSA was empowered to exercise discretion to deduct unpaid contributions and interest from any payment due to the state under the Social Security Act. See section 218(j) of the Social Security Act prior to repeal in 1986. In 1978, only the state, and not the employing governmental entities or the individual workers, had standing to bring suit against SSA for overpayment of section 218 contributions. See section 218(a) prior to its 1986 amendment. The scheme of social security contributions under a section 218 agreement was completely at odds with the focus of section 530, which is on whether an individual employing entity had a reasonable basis for treating its workers as independent contractors.

The Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509) amended the Social Security Act and the Code to provide that payments for coverage under section 218 agreements were FICA taxes. Section 3121(b)(7)(E) was added to the Code to provide that "employment" includes service included under an agreement entered into pursuant to section 218 of the Social Security Act. In addition, the definition of "employee" under section 3121(d) was expanded by adding section 3121(d)(4), which provides that the term "employee" includes any individual who performs services that are included under an agreement entered into pursuant to section 218

of the Social Security Act. The cumulative effect of these amendments is that the status of individuals covered under section 218 agreements as employees performing employment is not dependent upon whether they satisfy Service criteria for status as employees. Status as an employee is automatic upon coverage under a section 218 agreement.

The premise of section 530 is that, with respect to the employer's liability for federal employment taxes, an individual will not be treated as an employee despite his or her status as an employee. Thus, section 530 relief is not appropriate unless there has been a determination that an individual is an employee. Although section 530 specifically states that it is to apply relief in instances of misclassification based on the common law rules (section 3121(d)(2)), relief was also extended to officers (section 3121(d)(1)) and "statutory employees" (section 3121(d)(3)). See section 3.09 of Rev. Proc. 85-18. We know of no instance, however, in which an officer was ever granted relief under section 530.

The classification of an employee under sections 3121(a)(1), (2), or (3) is made under rules that are provided in the Internal Revenue Code and the regulations thereunder. The classification of a state or local government worker as an employee under section 3121(d)(4), however, is made specifically with reference to section 218 of the Social Security Act. If the individual is covered under a section 218 agreement, he or she is, by definition, an employee for FICA purposes. Section 530 relief is inappropriate, because coverage under the section 218 agreement is determinative of the individual's employment status.

The classification of state and local workers who are covered under section 218 agreements as employees under section 3121(d)(4) should be contrasted with the classification of other state and local workers. If the worker is not covered under a section 218 agreement, the determination of his or her status as an employee under the FICA will be made pursuant to section 3121(d)(2), which provides that the term "employee" includes an individual who is an employee under the usual common law rules. If the worker is an employee not covered under a section 218 agreement, the services of the worker are then examined to determine whether the services are "employment" for purposes of social security taxes and Medicare taxes, under sections 3121(b) and 3121(u).

Because the question of whether workers who are not covered under section 218 agreements are employees for purposes of the FICA is made under section 3121(d)(2) and is exclusively within the jurisdiction of the Service, the employee-independent contractor determination is ultimately made in the same manner as with private employers. Therefore, with respect to employees not covered under section 218 agreements, the argument about conflict with the section .218 agreement is inapplicable and section 530 relief applies if the taxpayer is able to demonstrate that he or she qualifies for it.

******* and Section 530 Relief**

Whether section 530 relief is available to ***** depends on whether its workers are subject to a section 218 agreement. With respect to its employees who are covered by the 218 agreement, ***** can not avail itself of section 530 relief. ***** could however, obtain relief with respect to those workers who are excluded from coverage under the 218 agreement.

******* and Section 530 Relief**

If ***** is not subject to a section 218 agreement, it may be entitle to relief under section 530. ***** offers two arguments in support of its contention that it is entitled to section 530 relief. First, it argues that it reasonably relied on Rev. Rul. 61-196 in treating its nurses as independent contractors. Second, it argues that the long-standing practice of a significant segment of the industry is to treat per diem nurses as independent contractors.

We do not agree that Rev. Rul. 61-196 provides a reasonable basis upon which to treat nurses as independent contractors. The facts in Rev. Rul. 75-101 are more like those in the present case as we described above. That nurses can be independent contractors under certain circumstances does not mean that ***** had a reasonable basis for treating its nurses as independent contractors, particularly since more recent rulings with more relevant facts have indicated otherwise.

Under the facts presented, it is possible that ***** relied on the practice of a significant segment of the industry. It is our position that 80 percent of an industry must treat its workers as independent contractors to constitute a

significant segment of the industry. An industry comprises all firms within a given geographic area with whom the taxpayer competes for business. See General Investment Corp. v. United States, 823 F.2d 337 (9th Cir. 1987). You stated that a survey of the per diem nursing industry indicated that 78 percent of the industry treats its nurses as independent contractors. If the other requirements of section 530 have been satisfied and you can determine that, in fact, almost 80 percent of the relevant industry treated its workers as independent contractors, section 530 relief could be available to *****. Note that the taxpayer must demonstrate not only the existence of a practice of a significant segment of the industry, but also that it reasonably relied on the practice of that industry.

There may be an issue as to whether the substantive consistency requirement of section 530 has been satisfied. If ***** treated nurses as employees and created ***** simply to reclassify its workers as independent contractors, the consistency rules of section 530 have not been satisfied.

Income Tax Withholding

A related issue is whether an employer can obtain section 530 relief from income tax withholding liability if relief from FICA taxes is unavailable because the employee is covered under a section 218 agreement. There is no-provision in Chapter 24, Collection of In come Tax at Source, similar to section 3121(d)(4), providing that a worker covered under a section 218 agreement is an employee. Because the Administrator's determination that an individual is covered under a section 218 agreement would generally be based on the common law rules, a similar result should be reached with respect to liability for income tax withholding after coordination with the Administrator. The Service, however, has jurisdiction over the determination of whether state and local workers are employees for federal income tax withholding purposes. There are distinctions between the definition of employee for purposes of income tax withholding and the definition of employee for purposes of the FICA (i.e., the existence of the statutory employee categories in the FICA) that give further support to differing section 530 treatment for FICA tax liability and income tax withholding liability of state and local employees covered under section 218 agreements.

The income tax withholding provisions have always been exclusively under the jurisdiction of the Service regardless of whether the workers are state and local employees under section 218 agreements. State and local governmental employees were, of course, subject to income tax withholding at the time of passage of section 530 and no exception was provided for application of section 530 to the income tax withholding liability arising from the services of such workers.

Because of the differing statutory definitions of employee under the FICA and the Collection of Income Tax at Source, we conclude that, if the requirements of section 530 are met, state and local employers may obtain section 530 relief with respect to income tax withholding liability, regardless of whether the reclassified worker is covered under a section 218 agreement.

As a general rule, relief under section 530 continues as long as the employer satisfies the reporting consistency rule (by issuing Forms 1099 when required) and the substantive consistency rule. Under the substantive consistency rule, the employer must treat any workers in substantially similar positions as not being employees to obtain section 530 relief. The withholding of FICA taxes is treatment of a worker as an employee under section 3.03 of Rev. Proc. 85-18. Granting state and local government entities relief from income tax withholding liability but not FICA taxes raises the question whether relief from income tax withholding liability will apply prospectively because the entities will be withholding and paying FICA taxes. The substantive consistency rule would seem to prevent the entity from obtaining continuing section 530 relief and require the withholding of income tax prospectively.

Rev. Proc. 85-18 provides a solution to the problem described in the previous paragraph. In particular, the rules provided in section 3.03(C) and 3.04 of Rev. Proc. 85-18 could apply to state and local governmental entities granted section 530 relief only for income tax withholding. Under Rev. Proc. 85-18, the filing of a delinquent or amended employment tax return for a particular tax period with respect to an individual as a result of Service compliance procedures is not "treatment" of the individual as an employee for that period. The procedure provides as an example that, if the Service determines as a result of an audit that a taxpayer's workers are common law employees, that determination is not "treatment" of the workers as employees for the period under

audit. However, if the taxpayer withholds employment taxes or files employment tax returns with respect to those workers for the periods following the period under audit, that action is “treatment” of the workers as employees for those later periods.

Section 3.04 of Rev. Proc. 85-18 also provides that a change in the treatment of the worker to “treatment as an employee” creates prospective liability only for the period after the audit. This section gives the example of a taxpayer who did not treat a worker as an employee in 1978 and 1979, but began treating individuals holding similar positions as employees in 1980. The procedure states that the employer could still receive relief under section 530(a)(1) for 1978 and 1979. Thus, applying these provisions of Rev. Proc. 85-18 to the case of workers covered under section 218 agreements, relief under section 530 can apply to retroactive liability for income tax withholding, but prospectively the employer would be liable for income tax withholding when the employer began withholding FICA taxes.

In summary, relief from retroactive income tax withholding liability under section 530 is available to state and local entities that can meet section 530’s requirements. If relief from income tax withholding liability is applied with respect to service covered under a section 218 agreement (but relief from FICA taxes is denied because the worker is covered under a section 218 agreement), the taxpayer would be required to withhold income tax prospectively with respect to such service.

Conclusions

Accordingly, we conclude that, in general, the workers in question appear to have been employees for the years in question. Most, if not all, of the ***** workers appear to have been covered by ***** section 218 agreement, with the possible exception of some of its student nurses. We were not presented any evidence indicating that ***** was covered by a section 218 agreement. Of course, this question must ultimately be resolved by the ***** Social Security Administrator. Finally, with respect to those workers covered by a section 218 agreement, ***** can not obtain relief from employment taxes under section 530. With respect to those workers who are not covered by a section 218 agreement, ***** and ***** can obtain section 530 relief if they otherwise qualify for it.

This technical assistance has been prepared with respect to the specific issues presented and the law has been applied to the relevant facts as we understand them. A copy of this memorandum should not be provided to the taxpayers. This memorandum may not be cited as authority in the examination of a taxpayer’s return. If you have any questions or if we can be of further assistance, you may contact Dean R. Morley of my staff at (202) 622-6040.

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Footnotes

1 With respect to services performed after July 1, 1991, section 3121(b)(7)(F) of the Code limits the exclusion from “employment” of section 3121(b)(7) to individuals who are members of a state retirement system. See section 3121(b)(7)-2 of the regulations.

2 There is no liability for OASDI taxes with respect to the wages paid to employees not covered by a section 218 agreement. There may, however, be liability for HI taxes, so the employer could obtain relief from them under section 530.