DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO WORKER CLASSIFICATION AND THE TAX TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS AND PARTNERS

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on May 3, 1994

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

May 2, 1994

JCX-6-94

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INTRODUCTION

As part of its continuing examination of health care reform issues, the Senate Committee on Finance has scheduled a hearing on May 3, 1994, regarding proposals contained in the Health Security Act, (S. 1757 introduced by Sen. Mitchell and others and S. 1775 introduced by Sen. Moynihan) relating to worker classification and the tax treatment of certain S corporation shareholders and partners. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and of the proposals.

Part I of the document presents background and an overview of the issues covered in the pamphlet in the context of health care reform; Part II of the document relates to worker classification; and Part III relates to the tax treatment of certain S corporation shareholders and partners.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description and Analysis of Proposals Relating to Worker Classification and the Tax Treatment of Certain S Corporation Shareholders and Partners (JCX-6-94), May 2, 1994. The description and discussion is principally derived from the previous Joint Committee pamphlet: Joint Committee on Taxation, Description and Analysis of Title VII of H.R. 3600, S. 1757, and S. 1775 ("Health Security Act") (JCS-20-93), December 20, 1993.

I. BACKGROUND AND OVERVIEW

A. Worker Classification

Under present law, significant tax consequences result from the classification of a worker as an employee or an independent contractor.[2] Some of these favor employee status, while others favor independent contractor status.

The determination of whether a worker is an employee or an independent contractor is made under a common-law test. Under this test, a worker is generally considered an employee if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished. Whether the requisite control exists is determined based on all the facts and circumstances. The Internal Revenue Service (IRS) has developed a list of 20 factors that may be examined in determining worker status. These factors were developed by the IRS based on an examination of cases and rulings.

In the late 1960s, the IRS increased enforcement of the employment tax laws, and controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 ("section 530"), which generally permits a taxpayer to treat an individual as not being an employee for employment tax purposes regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment and if certain additional requirements are satisfied. Section 530 does not apply for income tax purposes. Thus, the determination of whether an individual is an employee for income tax purposes is made without regard to section 530.

The present-law rules for determining whether a worker is an employee or an independent contractor continue to result in misclassification of workers and uncertainty among taxpayers. While the section 530 safe harbor provides a relatively clear rule for determining worker status for employment tax purposes, the safe harbor does not apply in all cases, so many employers must rely on the subjective common-law test.

Health care reform proposals do not create the issue of proper worker classification, but put more pressure on the determination of worker status. To the extent that a health care

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[2] There also may be nontax consequences, such as the applicability of wage and hour laws.

proposal relies upon worker classification to determine an employer's or individual's liability for health care premiums, eligibility for Federal subsidies, or any additional health care or tax liabilities, the importance of worker classification is increased. The Health Security Act would place greater significance on the proper classification of a worker as an independent contractor or employee. In addition to the consequences of present law, under the Health Security Act the classification of a worker would affect whether or not the service recipient is required to pay a health care premium for the worker. It could also affect the amount the employer is required to pay (because the aggregate amount is based on firm size and employee wages) and the Federal subsidy for health care premiums. Whether it is more beneficial to be an employee or independent contractor may be different under the bill than under present law. The increased significance of worker classification would mean that there would be even greater need for clarity of rules to help prevent worker misclassification. From an administrative perspective, if there is an employer mandate, a clear definition of employee would make the system easier to administer both for the private sector and government agencies involved. The greater differences there are between the consequences of being an employee and not being an employee, the more likely employers and individuals would take aggressive positions in order to achieve the outcome they desire.

B. Self-employment Tax Treatment of Certain S Corporation Shareholders and Partners

The present-law self-employment tax (SECA) on self-employed individuals is intended to parallel the FICA tax on wages of employees. Both taxes are intended to be imposed on the remuneration received from one's own labor. However, present-law SECA provides disparate treatment among different types of self-employed individuals (i.e., sole proprietors, general and limited partners in partnerships, and shareholders of S corporations) despite the fact that these individuals generally are treated similarly for Federal income tax purposes. In some cases the trade or business income of these individuals may be fully subject to SECA (e.g., in the case of sole proprietors and general partners); may be partially subject to SECA (e.g., in the case of limited partners); or may be excluded from SECA (e.g., in the case of S corporation shareholders, whose salaries are subject to FICA).

Various rationales can be put forth as to why it is appropriate to treat various individuals differently for SECA purposes. These rationales focus on the extent to which the stakeholders of a flow-through entity are active participants or mere investors and how the are compensated for these roles. Partners in partnerships generally do not draw salaries. Thus, specific rules must be developed for the treatment of their

earnings in the SECA base. In addition, the participation by limited partners in the activities of a partnership traditionally has been limited by local law. Because of the one-class-of-stock rule applicable to S corporations, shareholders that more actively participate in the corporation's business generally receive salaries as compensation for such activity. These salaries are subject to FICA. However, these traditional differences between general partners, limited partners, and S corporation shareholders are changing and differing employment tax treatment among such individuals may invite taxpayers to devise cosmetic structures to minimize their employment tax liabilities. In addition, to the extent that the Health Security Act or any other health care reform proposal relies upon the determination of aggregate wages (as defined under the employment tax rules), the significance of differing treatment among similarly-situated individuals increases.

The disparate treatment provided under SECA raises the following issues: (1) whether it is appropriate to provide different SECA rules for individuals who derive trade or business earnings from different types of flow-through entities; (2) whether it is possible to determine the theoretically correct employment tax bases for any or all types of self-employed individuals; and (3) whether it is possible to develop administratively feasible rules that adhere to these theoretical determinations.

II. WORKER CLASSIFICATION UNDER THE HEALTH SECURITY ACT

A. Definition of Employee and Protection Against Retroactive Employment Tax Reclassifications (secs. 7301 and 7303 of the bill)

1. Present Law

In general

In general, the determination of whether an employer-employee or independent contractor relationship exists for Federal tax purposes is made under a common-law test. Under this test, an employer-employee relationship exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished (Treas. Reg. sec. 31.3401(c)-(1)(b)). Whether the requisite control exists is determined based on the facts and circumstances.

The Internal Revenue Service (IRS) has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. Rev. Rul. 87-41, 1987-1 C.B. 296. The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a worker is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The 20 factors are designed as guides; special scrutiny may be required in applying the factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement.[3]

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[3] The factors are as follows: (1) whether the worker is required to comply with instructions about when, where, and how to perform the work; (2) whether the service recipient trains the worker; (3) the extent to which the worker's services are integrated into the business operations of the service recipient; (4) whether the services must be rendered personally; (5) whether the service recipient supervises the worker; (6) whether there is a continuing relationship between the worker and the service recipient; (7) whether the service recipient sets the hours of work of the worker; (8) whether the worker is required to devote substantially full time to the business of the service recipient; (9) whether the work is done on the premises of the service recipient; (10) whether the worker must perform services in the order set by the service recipient; (11) whether reports by the worker to the service recipient are required; (12) whether payment is by the hour, week, or month; (13) whether the service recipient pays the worker's business and/or traveling expenses; (14) whether the worker is required to furnish his or her own tools; (15)

In addition to the common-law test, there are statutory provisions classifying workers as employees or independent contractors. Thus, for example, full-time life insurance salesmen are treated as employees for certain purposes pursuant to statutory provisions (secs. 3121(d) and 7701(a)(20)). Similarly, certain real estate agents and direct sellers are not treated as employees (sec. 3508).

Section 530 of the Revenue Act of 1978

In the late 1960s, the IRS increased enforcement of the employment tax laws, and controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as independent contractors rather than as employees. In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 ("section 530"), which generally permits a taxpayer to treat an individual as not being an employee for employment tax purposes regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment and if certain additional requirements are satisfied.[4] Section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[5]

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whether the worker invests in facilities used to perform the work; (16) whether the worker can realize a profit or loss as a result of the performance of the services; (17) whether the worker performs services for more than one service recipient; (18) whether the worker makes his or her services available to the general public; (19) whether the service recipient has the right to discharge the worker; and (20) whether the worker has the right to terminate the relationship without incurring liability.

[4] The relief granted by section 530, initially scheduled to terminate at the end of 1979, was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (P.L. 97-248), the Congress extended the section 530 relief indefinitely, pending enactment of further statutory rules regarding the classification of workers as employees or independent contractors.

[5] This provision was contained in section 1706 of the Tax Reform Act of 1986, (P.L. 99-514), effective for remuneration paid and services rendered after December 31, 1986.

Under section 530, a reasonable basis is deemed to exist for a period if the taxpayer reasonably relied on any of the following: (1) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer; (2) a past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by the individual in question; or (3) long-standing recognized practice of a significant segment of the industry in which such individual was engaged. These factors are a safe harbor, not the exclusive means of meeting the reasonable basis requirement.

In order to qualify for section 530 relief, certain conditions must also be satisfied. In particular, section 530 does not apply if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after December 31, 1977. In addition, section 530 does not apply unless all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee.

Section 530 also bars the Department of Treasury (including the IRS) from publishing any regulation or revenue ruling classifying individuals for purposes of employment taxes under interpretations of the common law. Taxpayers may, however, obtain private letter rulings from the IRS regarding the status of workers.

Section 530 does not apply for income tax purposes. Thus, the determination of whether an individual is an employee for income tax purposes is made without regard to section 530.

2. Description of Bill

In general

The bill would (1) repeal section 530 of the Revenue Act of 1978, (2) codify a modified version of section 530 which protects taxpayers against retroactive reclassification of workers as employees, and (3) give the Secretary of the Treasury the authority to define the term "employee" by regulation. The modified rules would apply for income tax purposes, employment tax purposes, and for purposes of the bill's health care provisions.

Codification and revision of section 530

The bill would repeal section 530 of the Revenue Act of 1978 and incorporate a modified version in the Internal Revenue Code.

Under the bill, an individual would not be treated as an employee of a taxpayer for any period if, for that period:

(1) the taxpayer treats the individual as not being an employee;

(2) the taxpayer treats the individual (and all other individuals holding substantially similar positions) as not being an employee for employment tax purposes for such period and all prior periods;

(3) a return filing requirement is met;

(4) a safe harbor requirement is met; and

(5) the Secretary has not notified the taxpayer in writing before the beginning of such period that the Secretary has determined that the taxpayer should treat such individual (or any individual holding a substantially similar position) as an employee.

The return filing requirement would be met if all Federal tax returns (including information returns) required to be filed by the taxpayer for such period with respect to such individual (and all other individuals holding substantially similar positions) were timely filed on a basis consistent with the taxpayer's treatment of such individuals as not being employees. For purposes of this requirement, a return that was not timely filed would be considered to have been timely filed if the penalty for failure to file is reduced or waived because the failure was corrected or because it was a de minimis failure pursuant to section 6721(b) and (c). In addition, the taxpayer would not fail to satisfy the return filing requirement solely because the taxpayer failed to timely file accurate information returns with respect to individuals holding substantially similar positions if the taxpayer substantially complied with reporting requirements (as defined in proposed new Code sec. 6721(a)(3)).

The safe harbor requirement would be met with respect to an individual for any period if treating such individual as not an employee was:

(1) in reasonable reliance on a written determination regarding the taxpayer that addressed the employment status of the individual or an individual holding a substantially similar position;

(2) in reasonable reliance on a concluded IRS audit which was for a period in which the rules for determining employment status were the same as for the period in question, and in which the employment status of the individual (or an individual holding a substantially similar

position) was examined and accepted;

(3) in reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the individual is engaged; or

(4) supported by substantial authority (excluding for this purpose letter rulings regarding other taxpayers).

No other means could be used to demonstrate reasonable reliance.

The prior audit safe harbor would cease to apply to an individual for a period if the treatment of such individual as not being an employee is inconsistent with any regulation, revenue ruling, revenue procedure, or other authority published by the Secretary before the beginning of the period and after conclusion of the audit on which the taxpayer is relying.

The availability of the industry practices safe harbor would terminate for all workers for periods beginning after the date on which the Secretary prescribes regulations defining "employee" and could terminate with respect to particular workers for earlier periods if the treatment of such workers as not being employees was inconsistent with any other regulation, revenue ruling, revenue procedure, or other authority published by the Secretary before the beginning of such earlier period.

The bill would provide that if an individual was treated as not being an employee under the safe harbor rules for employment taxes, then the individual would be treated as self-employed for income tax purposes as well.

Treasury regulations defining employee

The bill would authorize the Secretary of the Treasury to prescribe rules for determining whether an individual is an employee. These rules would apply for employment tax purposes and, to the extent provided in the regulations, for income tax purposes. Such regulations could modify the rules otherwise applicable for determining whether someone is an employee, except for certain statutory rules. The regulations would be required to give significant weight to the common-law rules. The following statutory provisions could not be modified by the regulations: (1) the rules providing that the following persons are treated as employees (a) corporate officers (sec. 3121(d)(1)), (b) certain agent-drivers or commission-drivers, full-time life insurance salesmen, home workers, and traveling salesmen (sec. 3121(d)(3)); and (c) individuals who perform services that are included under an agreement entered into pursuant to section 218 of the Social Security Act (relating to voluntary coverage of certain State and local government employees)(sec. 3121(d)(4)); (2) the rule

providing that for employment tax purposes a person who provides companion sitting services is not an employee of any person who places the individual with the service recipient (sec. 3506); (3) the rule providing that certain real estate agents and direct sellers are not employees (sec. 3508); and (4) the new safe harbor provisions described above (proposed new Code sec. 3511). The regulations issued under this provision could not be effective earlier than 6 months after the regulations are promulgated as final regulations. When the regulations are issued, the Secretary of the Treasury is to submit a report to Congress relating to such regulations, including an explanation of their purposes and the issues they were designed to address.

Effective date.--The provision relating to section 530 would generally be effective for periods beginning after December 31, 1995, except that the repeal of the prohibition on the issuance of regulations and rulings would be effective on the date of enactment. The provision authorizing regulations defining "employee" would be effective on the date of enactment.

3. Discussion of Issues

Tax issues relating to the definition of employee

Under present law, significant tax consequences result from the classification of a worker as an employee or an independent contractor.[6] Some of these differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. They also relate to whether the service recipient has to include the worker for pension or other employee benefit plan purposes. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

The present-law rules for determining whether a worker is an employee or an independent contractor continue to result in misclassification of workers and uncertainty among taxpayers. While the section 530 safe harbor provides a relatively clear rule for determining worker status, the safe harbor does not apply in all cases, so many employers must rely on the common-law test.

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[6] There may also be nontax consequences, such as applicability of wage and hour laws.

Misclassification of workers can be either inadvertent or deliberate. At the extremes, it will be clear whether a worker is properly characterized as an employee or an independent contractor. However, many work situations involve the grey area in between--some of the 20 factors may support employee status, while some may indicate independent contractor status. Thus, it may be difficult to determine whether a particular case of misclassification was deliberate or inadvertent.

Inadvertent misclassifications can occur because the determination of proper classification is factual and reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. Taxpayers wishing certainty can obtain a private letter ruling regarding the status of workers. However, not all taxpayers may wish to undertake the expense of obtaining a ruling or may not be able to wait for a ruling from the IRS. Thus, although the prohibition on issuance of general guidance by the IRS may make the likelihood of such errors greater, the IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and the IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement.

Misclassification of workers as independent contractors may also be deliberate. In some cases, workers and service recipients may prefer to classify workers as independent contractors, both for tax and nontax reasons. For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. A service recipient may wish to avoid the administrative burden associated with withholding income and employment taxes. The service recipient also may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors.

The bill would place greater significance on the proper classification of a worker as an independent contractor or an employee.[7] In addition to the consequences of present law, under

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[7] The health care provisions of the bill may also affect whether firms out-source some of their work or hire subcontractors to perform it because the amount of Federal subsidies and employer premiums may vary based on whether work is performed by subcontractors or through similar arrangements. While some of these arrangements may involve questions as to whether the worker is an employee of the service recipient, in many cases the question will

the bill the classification of a worker would affect whether or not the service recipient is required to pay a health care premium for the worker. It could also affect the amount the employer is required to pay (because the aggregate amount is based on employee wages) and the Federal subsidy for health care premiums. Whether it is more beneficial to be an employee or independent contractor may be different under the bill than under present law. The increased significance of worker classification would mean that there would be even greater need for clarity of rules to help prevent worker misclassification.

Section 530 is supported by those who take advantage of it because it provides some certainty and protection to taxpayers in an area of law that is far from clear. However, section 530 has also been criticized. Not all taxpayers can use the section 530 safe harbors. For example, the consistency requirement may prevent some taxpayers from using section 530. Taxpayers who cannot take advantage of section 530 argue that it creates a competitive disadvantage that is particularly unfair because they are classifying their workers under the general rule. Section 530 has also been criticized because it may take very little to come within one of the safe harbors if section 530 is otherwise available to a taxpayer. For example, the prior audit rule has been criticized because the audit need not have been an employment tax audit. Thus, section 530 could apply even if worker status was not raised on the audit. The industry practice safe harbor has been criticized on the ground that it rewards people who have consistently misclassified workers. Limiting the scope of these provisions would be viewed as more fair to taxpayers who cannot take advantage of section 530, and would also be more consistent with tax policy concerns.

Codifying the safe harbors could provide more certainty to taxpayers. In addition, lifting the prohibition on issuance of guidance would enable the IRS to issue clarifying rules. Overall, however, it is difficult to determine what effect the provisions of the bill would have on classification of workers. It is not clear to what extent modifying the safe harbors will actually reduce the number of taxpayers who take advantage of them. For example, a taxpayer that was relying on the prior audit safe harbor but could not do so under the bill might rely instead on the industry practice safe harbor. The bill would give the Treasury Department the authority to terminate the application of the industry practice safe harbor, but until actual rules are proposed, it is difficult to determine what effect they will have. The same issue arises in trying to determine what effect regulations defining "employee" would have. Clarifying the statutory rules would provide more certainty to both taxpayers

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not arise because the worker is the employee of the subcontractor.

and the IRS.

Another way to deal with the misclassification issue, other than clarifying the rules, would be to reduce the differences between the treatment of employees and independent contractors. The more the two groups of workers are treated the same for purposes of the employer mandate and the receipt of Federal subsidies, the less pressure there will be on the definition of employee. It has also been suggested that compliance problems could be addressed, such as requiring withholding on payments to independent contractors.[8]

Under present law, section 530 applies only for employment tax purposes. In general, the provision would apply the same definition of employee for income tax purposes and employment tax purposes. This would likely reduce taxpayer confusion and ease administration of the tax rules. Under present law, some individuals who are treated as not being employees under the safe harbor mistakenly use that status in filing their income tax returns. A single definition would avoid such mistakes.

Health care policy issues

The question of who is an employee is fundamental to the provisions of the bill because it has a mandated employer contribution.[9] The question of whether there should be such a mandate and whether or not health care should be delivered through the employer is obviously a central issue in health care reform.[10] From an administrative perspective, if there is an employer mandate, a clear definition of employee would make the system easier to administer both for the private sector and government agencies involved. The greater differences there are between the consequences of being an employee and not being an employee, the more likely employers and individuals would take aggressive positions in order to achieve the outcome they desire.

Even if there is to be an employer mandate or employer-based system, it is not clear that the definition of employee for

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[8] See, U.S. General Accounting Office, Approaches for Improving Independent Contractor Compliance, GAO/GGD-92-108 (July 1992).

[9] Worker classification issues also may arise in health care proposals that do not have a mandated employer contribution.

[10] Discussion of issues relating to employer mandates and use of an employer-based health care delivery system is beyond the scope of this pamphlet.

health care purposes should be the same as it is for other purposes. Different policies may underlie the health care rules and income and employment tax rules, and these policies could lead to different conclusions about proper classification. Thus, it may not be necessary to examine the question of worker status for income and employment tax purposes in the context of health care reform. On the other hand, overall administrative burdens on employers, individuals, the IRS, and those responsible for administering the health care system and the income and employment tax systems would be less if the rules are the same.

B. Increase in Penalties for Failure to File Correct Information Returns with Respect to Non-employees (sec. 7302 of the bill)

1. Present Law

Information reporting requirements

The Code contains a number of information reporting requirements. One requires that a person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income, must file an information return with the IRS reporting the amount of such payments, as well as the name, address and taxpayer identification number of the person to whom such payments were made.[11] A similar statement must also be furnished to the person to whom such payments were made.[12]

The Code contains an additional provision requiring that a service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is

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[11] Sec. 6041(a). A number of exceptions to this requirement are provided in Treasury regulations. In addition, to the extent the general information reporting requirements of this provision overlap specific information reporting requirements elsewhere in the Code, taxpayers are generally required to report only once, under the more specific information reporting provision.

[12] Sec. 6041(d).

$600 or more.[13] Also, the service-recipient must furnish to the person receiving such payments a statement setting forth the name, address, and taxpayer identification number of the service-recipient, and the aggregate amount of payments made to the payee during the year.[14]

Failure to file correct information returns

Any person that fails to file a correct information return[15] with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed (sec. 6721). If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1, the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, special, lower maximum penalty levels apply for

[13] Sec. 6041A(a).

[14] Sec. 6041A(e).

[15] This term is defined in sec. 6724(d)(1), and refers to 21 information reporting requirements in the Code, including secs. 6041(a) and 6041A(a).

small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent 3 taxable years that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

Failure to furnish correct payee statements

Any person that fails to furnish a correct payee statement[16] to a taxpayer on or before the prescribed due date is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year (sec. 6722). If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, there is a penalty of $100 per statement or, if greater, 10 percent[17] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year (sec. 6723). The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or a statement and any requirement to furnish a correct taxpayer identification number to another person.

Waiver, definitions, and special rules

Any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect (sec. 6724). For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.

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[16] This term is defined in sec. 6724(d)(2), and refers to 22 information reporting requirements in the Code, including secs. 6041(a) and 6041A(a).

[17] Five percent for several types of statements.

2. Description of Bill

The bill would modify the penalty for failure to file correct information returns with respect to two types of information returns: (1) information returns under section 6041(a) which relate to payments to any person for services performed by such person (other than as an employee);[18] and (2) returns regarding remuneration for services under 6041A(a). In general, both of these sections of the Code relate to information returns with respect to payments made to non-employees, such as independent contractors.[19]

In general, the bill would increase the penalty for failure to file correct information returns on or before August 1 from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported correctly but not so reported.

The bill would also provide for an exception to this increase where substantial compliance has occurred. The bill would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported under these two sections of the Code for that calendar year is at least 97 percent of the aggregate amount required to be reported under these two sections of the Code for that calendar year. If this exception applies, the penalty of $50 for each return would continue to apply.

The present-law reductions in the $50 penalty where correction is made within a specified period, the exception for de minimis failures, and the lower limitations for persons with gross receipts of not more than $5,000,000 would not be affected by the bill. Also, the penalty for failure to furnish correct payee statements, the penalty for failure to comply with other information reporting requirements, and the reasonable cause rules would not be affected by the bill.

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[18] It is intended that the modification to the penalty apply only to information returns reporting payments for services performed that are made to non-employees under section 6041(a), and not with respect to other types of information returns filed under section 6041(a). A technical correction to the statutory language may be necessary to effect this result.

[19] Employers are required to provide information with respect to wages paid to their employees on Form W-2 under section 6051; consequently, those information returns would not be affected by the bill.

Effective date.--The provision would apply to information returns the due date for which (without regard to extensions) is more than 30 days after the date of enactment.

3. Discussion of Issues

One issue to consider is whether the increase in the penalty for failure to file correct information returns will result in a penalty that is proportional to the offense of failing to report. Some might argue that the resulting penalty could be disproportionately high, particularly in light of the fact that intentional disregard or willfulness are not required to be asserted or proven in order to impose the higher penalty. Others might argue that the penalty is not disproportionate to the offense because information returns filed by companies with respect to the independent contractors they engage are the principal means by which the IRS learns from someone other than the taxpayer of the existence and amounts of these payments. This is important under the bill because some self-employed individuals will be entitled to discounts on their health insurance premiums based upon their income, so that correct reporting of payments will be necessary to determine entitlement to these discounts. In addition, some might argue that the increased penalty is not disproportionate because the increase does not apply where correction is made within a specified period, within certain de minimis guidelines, or where there is reasonable cause.

An additional issue to consider is how well the increased penalty fits into the current information reporting penalty structure. For example, the increased penalty is parallel in structure to the penalty for intentional disregard of the information reporting requirements (sec. 6721(d)). The difference is the rate: the increased penalty would be 5 percent of the amount required to be reported, while the penalty for intentional disregard is 10 percent. Consideration might be given as to whether the differential between the two penalties should be adjusted. Another aspect of how the increased penalty fits into the current information reporting penalty structure is whether the increased penalty should also apply to failures to furnish correct payee statements (sec. 6722). Under the bill, the increased penalty applies only with respect to the failure to file a correct information return with the IRS, and it does not apply to the failure to provide a correct copy of the information return to the individual with respect to whom the information is reported. Another aspect of how the increased penalty fits into the current information reporting penalty structure is whether, in light of this increased penalty, the overall annual caps on the total amount of penalty that may be imposed should remain the same (as they do under the bill) or should be adjusted.

III. MODIFICATION TO SELF-EMPLOYMENT TAX TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS AND PARTNERS (sec. 7141 of the bill)

A. Present Law

Employment taxes, in general

As part of the Federal Insurance Contributions Act (FICA), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is composed of two parts: old-age, survivor, and disability insurance (OASDI) and Medicare hospital insurance (HI). For wages paid in 1993, to covered employees, the OASDI tax rate is 6.2 percent on both the employer and employee on the first $57,600 of wages and the HI tax rate is 1.45 percent on both the employer and employee on the first $135,000 of wages.

Similarly, under the Self-Employment Contributions Act (SECA), a tax is imposed on an individual's net earnings from self-employment (NESE). The SECA tax rate is the same as the total FICA rates for employers and employees (i.e., 12.4 percent for OASDI and 2.9 percent for HI) and, for 1993, is capped at the same levels. In general, the SECA tax is reduced to the extent the individual had wages for which FICA taxes were withheld during the year.

The cap on wages and NESE subject to the OASDI portion of FICA and SECA taxes is indexed to changes in the average wages in the economy. The cap on wages and NESE subject to the HI tax is repealed for wages and income received after December 31, 1993.

Treatment of partners and S corporation shareholders

The NESE of a partner in a partnership generally is the partner's distributive share from any trade or business of the partnership, adjusted for certain items of income that are passive in nature (e.g., rentals of real estate, dividends, and interest are excluded from NESE unless such amounts are received in the course of a trade or business of a dealer in the related property). However, the distributive share of a limited partner generally is excluded from NESE except to the extent the distributive share is a guaranteed payment for services actually rendered to or on behalf of the partnership.

Similar rules are not provided for shareholders in S corporations.[20] Thus, shareholders are not required to include

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[20] For some purposes, a shareholder that owns more than 2 percent of the stock of an S corporation is treated as a partner in a partnership (sec. 1372(a)). However, this rule does not apply

as NESE their pro rata share of the income of an S corporation.[21] Rather, shareholders who perform services for the S corporation are subject to FICA taxes on the wages paid to them.[22]

B. Description of Bill

The bill would: (1) amend the definition of NESE to include the pro rata share of certain S corporation income of certain shareholders and (2) modify the NESE rules applicable to limited partners in a partnership, for SECA tax and health insurance premium purposes.

Under the bill, in the case of a "2-percent shareholder" of an S corporation for any taxable year who materially participates in the activities of the corporation during the year, NESE would include the shareholder's pro rata share of taxable income or loss from "service-related businesses" carried on by the S corporation. A "2-percent shareholder" would be any shareholder that owns more than 2 percent of the stock of an S corporation at any time during the year (sec. 1372(b)). The shareholder's pro rata share of the income or loss of an S corporation would be determined pursuant to the general rules of subchapter S (sec. 1366). A "service-related business" would be any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees. The present-law exclusions from NESE for certain

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for employment tax purposes.

[21] See, Rev. Rul. 59-221, 1959-1 C.B. 225.

[22] Furthermore, a shareholder of an S corporation may be subject to FICA tax even if the shareholder is not paid amounts denominated as "wages" by the corporation. In Rev. Rul. 74-44, 1974-1 C.B. 287, the IRS held that two shareholders who performed services for an S corporation but did not draw salaries were subject to FICA tax on dividend distributions from the corporation because the dividends represented reasonable compensation for the services performed. The present-law validity of this 1974 ruling following the substantial revision of the rules that apply to S corporations and their shareholders in 1982 is unclear.

However, it is the present position of the IRS that if a shareholder is an officer of an S corporation and performs substantial services, such shareholder is an employee of the corporation whose income is subject to FICA (but not SECA) tax. See, Department of the Treasury, "Tax Guide for Small Businesses" (for use in preparing 1992 returns), Publication 334, p. 136.

passive income that apply to partnerships would also apply to S corporations.

The bill also would amend the treatment of limited partners in a partnership by providing that the distributive share of a limited partner would be excluded from NESE only if the partner does not materially participate in the activities of the partnership. The provision retains the present-law guaranteed payment rule for limited partners who provide services for the partnership.

The bill would make conforming amendments to the Social Security Act.

Effective date.--The provision would apply to taxable years of individuals beginning after December 31, 1995, and to taxable years of S corporations and partnerships ending with or within such taxable years of individuals.

C. Discussion of Issues

Disparities created by present law

In general, partnerships and their partners and S corporations and their shareholders are treated similarly for Federal income tax purposes. The income of a partnership or S corporation is not subject to tax at the entity level, but rather is flowed through to the partners or shareholders and reported on their individual income tax returns, regardless of whether or when the income is actually distributed to the individuals. In contrast, the income of a subchapter C corporation is subject to an entity-level income tax when it is earned and is subject to the individual income tax when it is distributed to the individual shareholders of the corporation.

The SECA tax on the earnings of self-employed individuals parallels the FICA tax on the wages of employees. Both taxes are intended to be imposed on remuneration received for one's own labor. Under this theory, income that is a return on capital investment should not be subject to SECA. Difficulties arise when an individual provides both investment capital and labor services to an enterprise and has control over whether the remuneration for such services is in the form of salary (subject to FICA) or a distribution of the net earnings of the enterprise (generally subject to neither FICA nor SECA when distributed). This issue is less problematic with respect to services provided by a shareholder-employee of a subchapter C corporation because there is an incentive to pay the individual a salary (subject to FICA) in order to claim a corporate income tax deduction for such amount. However, no such incentive applies with respect to flow-through entities. Thus, rules are needed to determine what portion, if any, of the income of a partnership or S corporation

is subject to SECA at the partner or shareholder level.[23]

Present law treats all trade or business income earned by a partnership and allocated to general partners as NESE, regardless of whether such partners are material participants or mere investors. Thus, present law assumes that all partnership trade or business income that is allocated to a general partner is remuneration for services performed by the partner. Income allocated to limited partners is not NESE (unless in the form of a guaranteed payment for services rendered), on the theory that such partners have limited participation in the operation of the partnership and should not be entitled to social security benefits by virtue of their investment.[24]

Under present law, income allocated to a shareholder in an S corporation is not subject to NESE. This exclusion may be based on the theory that because S corporations are allowed to have only one class of stock, a shareholder that provides services to the corporation would draw a salary for such services, while a passive co-investor shareholder would not.[25] For example, assume two individuals form an S corporation by making equal capital contributions. One shareholder provides services to the venture and the other does not. Because the two shareholders have an equal number of shares in the corporation, a salary (subject to FICA) is needed in order to adequately compensate the service

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[23] It should be noted that because the determination of NESE generally is based on income tax rules, the method by which a business is capitalized also affects the NESE of the owner. A business that is capitalized with debt generally will generate lower NESE than an a business that is capitalized with equity because the returns on debt (interest expense) are deductible while the returns on equity (dividends, distributive share, etc.) are not.

[24] Legislative history indicates that the definition of NESE was amended to exclude distributive shares of limited partners because of a concern that certain business organizations were soliciting investments in limited partnerships as a means for the investor to become insured for social security benefits. House Ways and Means Committee Report on P.L. 95-216 (1977).

[25] Conversely, partnerships are viewed as entities that allow greater flexibility with respect to the allocation among the partners of income or loss from partnership activities. Partnerships do not pay salaries for services rendered by the partners. Rather, the partnership agreement may provide special allocations of partnership income to those partners who provide services to or on behalf of the partnership. Such allocations of income may be respected for Federal income tax purposes if they have substantial economic effect.

provider. Any income remaining after the payment of the salary would be deemed a return on the capital investments of the shareholders and not subject to SECA or FICA taxes. However, the application of this theory may result in an under-inclusion of earnings for employment tax purposes in some cases. For instance, if both shareholders in the example above provide an equal amount of services to the corporation, there is no need to pay salaries to equalize their contributions, and each shareholder's pro rata share of the corporate earnings would not be subject to SECA (although the IRS may contend that the shareholders are subject to FICA on all or a portion of the S corporation's earnings).[26]

If the two individuals in the two examples above formed a general partnership rather than an S corporation, each partner's distributive share of partnership trade or business income would be NESE, regardless of the level of activities by the partners. Thus, present law treats general partners in a partnership differently than shareholders in an S corporation for employment tax purposes, despite the fact that a partnership and its partners and an S corporation and its shareholders are treated similarly for income tax purposes.

Treatment under the bill

The bill would broaden the SECA base and narrow the disparate SECA treatment between income earned by partnerships and S corporations by treating as NESE the pro rata share of income of certain S corporation shareholders. Under the bill, NESE would include the pro rata share of S corporation income: (1) of a 2-percent shareholder; (2) who materially participates in the activities of the corporation; (3) but only to the extent the income is from a service-related trade or business. Each of these three tests raise certain issues.

Two-percent shareholders.--Present law treats 2-percent shareholders as individuals in control of the corporation for fringe benefit purposes (sec. 1372(a)). Thus, the "2-percent shareholder" test of the bill appears consistent with the present-law treatment of 2-percent shareholders for employment related purposes. In addition, in practice, most S corporation shareholders who are not 2-percent shareholders likely are employees whose wages are subject to FICA or minority investors who are not involved in the operations of the corporation.

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[26] The identical issue arises if the corporation is owned by a sole shareholder. It is reported that, based on 1990 data, approximately 80 percent of S corporations have only one or two shareholders. Susan C. Nelson, "S Corporations: The Record of Growth After Tax Reform", Journal of S Corporation Taxation, Vol. 5, No. 2, Fall 1993, p. 146.

Material participation.--Under the bill, a 2-percent shareholder need not include his or her pro rata share of S corporation earnings as NESE unless the shareholder materially participates in the activities of the S corporation. This test may be appropriate under the theory that a shareholder's pro rata share of S corporation earnings is not remuneration for the services provided by the shareholder unless the shareholder materially participates in the activities of the corporation.

In many instances, the material participation test may be redundant with the 2-percent shareholder test (e.g., in the case of an S corporation owned by a sole shareholder-employee). However, where there are multiple shareholders with multiple duties, a determination as to the material participation of each shareholder would be required. These determinations may be difficult. The bill does not define "material participation." The term is used under SECA to include certain farm rental income as NESE (sec. 1402(a)(1)),[27] as well as elsewhere in the Code to determine whether an individual may deduct losses from certain activities in which he or she materially participates (the passive loss rules of sec. 469). Under the passive loss rules, "material participation" means involvement in the operations of an activity on a basis that is "regular, continuous, and substantial," a more rigorous test than under section 1402.[28] Treasury regulations under sections 469 and 1402 provide further guidance as to when a taxpayer's involvement constitutes material versus passive participation, for the respective purposes of the two provisions. Despite this guidance, however, the determination of "material participation" under either section is often thought to be a difficult and subjective process.

The bill also would apply a material participation test (but not the "2-percent shareholder" or "service-related trade or business" tests) to limited partners. Section 469 provides that,

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[27] Under present law, the NESE of a owner or lessee generally does not include rent paid in a share of agricultural or horticultural production pursuant to an arrangement unless the owner or lessee materially participates in the production or management of the commodity produced.

[28] It should be noted that "material participation" is used for different purposes under sections 469 and 1402. Under section 1402, the term is used to expand the SECA tax base to include the farm income of certain individuals. Under section 469, the term is used to determine whether certain losses incurred by individuals are deductible for income tax purposes. Thus, an individual generally would want to be a "material participant" for income tax purposes with respect to loss-generating activities, but would not want to be a "material participant" for SECA purposes with respect to certain farm income-generating activities.

except as provided in regulations, the activities of limited partners do not constitute material participation. Treasury regulations provide instances in which the activities of a limited partner override this presumption. In general, it is more difficult for a limited partner to sustain material participation than it is for a general partner under section 469.

Although "material participation" may be an appropriate standard for determining when the activities of an S corporation shareholder or limited partner give rise to earnings that should be subject to SECA, the application of such a standard may be administratively difficult. Conversely, if the application of the standard proves to be administratively feasible, consideration should be given to applying the standard to general partners in partnerships as well.

Service-related trade or business.--Under the bill, only the portion of the pro rata share of the income or loss of a 2-percent shareholder who materially participates that is attributable to certain service-related trades or businesses is subject to NESE. This test would require an S corporation to determine if it is engaging in such activities and, if it is, to segregate the earnings from such activities from earnings of other activities. "Service-related trade or business" is defined with reference to a provision that was enacted with the Omnibus Budget Reconciliation Act of 1993 that allows for a partial capital gains exclusion for the gain on the sale of the stock of certain corporations engaged in active trades or businesses (sec. 13113 of the 1993 Act, adding sec. 1202 to the Code). "Service-related trade or business" generally means the activities of certain professions that are more dependent upon personnel skills than upon capital investment.

The "service-related trade or business" test may create some administrative difficulties. It may be difficult for an S corporation to determine if it is engaging in covered activities, due to the relative newness and subjectivity of the term.[29] Furthermore, if an S corporation engages in more than one business, it would be required to segregate the earnings from covered activities from other activities (e.g., an allocation may be necessary if an S corporation is involved in both architectural design and building construction). Income determinations for separate trades or businesses are particularly difficult (and manipulable) where the different trades or businesses share common costs such as overhead or interest

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[29] Present-law sections 401(c)(2) (relating to employee benefit plans) and 911(d)(2) (relating to an exclusion for foreign earned income) of also provide distinctions between income earned from personal services and other income. Neither definition was adopted by the provision.

expense. In addition, the use of a "service-related trade or business" test may provide an incentive for a service provider to break-up a single business into separate lines of business in order to minimize its NESE (e.g., an accounting firm that prepares computer-generated tax returns may claim to be in two businesses--the provision of income tax advice and the mechanical preparation of tax returns.)

The "service-related trade or business" test may be deemed appropriate for SECA purposes on the theory that passive investors are unlikely to invest where the success of the business is dependent upon the skills of another individual rather than the application of capital. As such, the "service-related trade or business" test may be redundant with the "2-percent shareholder" and "material participation" tests and may add little other than complexity to the employment tax rules. Conversely, if an entity-level activity test is appropriate as a separate standard for SECA purposes and is administrable, the question arises as to whether the test should be applied to partnerships as well. For example, under the bill, NESE would include income from manufacturing activities conducted through a general partnership, but not through an S corporation.

Other employment tax exceptions

In many instances, the bases for the FICA and SECA payroll taxes are broader than the base of the income tax with respect to the earned income of individuals. For example, several deductions and exclusions that are allowed for income tax purposes are not allowed for employment tax purposes.[30] The bill would further expand the SECA base to include additional trade or business income of self-employed individuals by eliminating present-law exceptions with respect to the incomes of certain S corporation shareholders and limited partners. If one of the goals of the bill is to expand the employment tax bases to include as much earned income as possible, consideration should be given as to whether there are any other present-law exceptions and whether these exceptions are warranted. One question to be kept in mind in determining whether an employment tax exception is warranted is whether the individual should be entitled to social security (or health care) benefits by virtue of the activity to which the exception applies.

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[30] For example, the net operating loss deduction of section 172, the personal exemptions of section 151, and the exclusion for income earned abroad of section 911 are not allowed for SECA purposes.