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View From Morgan Lewis: What Does Newport, Vermont, Have to Do With the Implementation of the ACA?

BY DAVID R. FULLER

Newport, Vt., is a hamlet of only 5,000 people straddling the Canadian border on beautiful Lake Memphremagog. So what can it have in common with the implementation of the Affordable Care Act? A very odd question indeed, but one that will likely become apparent in the months and years to come.

Even prior to the ACA's enactment, we have alerted clients to be on the lookout for IRS letters with the postmark of ''Newport, VT.'' If such a letter is received, the client has a potentially serious worker classification issue on their hands. That is because besides hosting ice fishing festivals in winter and sailboat regattas in the summer, Newport is one of only two locations in the entire United States to house an IRS SS-8 Unit—the sole function of which is to make and issue determinations under Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, addressing whether workers are employees or independent contractors. Almost all prior SS-8 determinations have addressed or been triggered by the following employment taxes: Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, federal income tax withholding (FITW) and Self Employment Contributions Act (SECA) taxes.

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Requests for SS-8 determination are often initiated by an independent contractor for one or more of the following reasons: 1. the IRS has notified the contractor that he or she has underpaid his/her estimated taxes, 2. the contractor seeks to recoup one-half of the self-employment contribution (SECA) taxes, and/or 3. the worker is seeking to be reclassified to become eligible for employee benefits. The IRS, in turn, seeks to recoup FICA, FUTA and FITW from the service recipient. Whatever the trigger for the SS-8 determination request, a skilled tax adviser can assist in defusing each of these issues through a combination of statutory, administrative and planning techniques.

Businesses and tax practitioners should anticipate that both the focus of the SS-8 determination requests, the number of requests and the results of challenging the IRS on worker classification out of Newport, Vt. (and Holtsville, N.Y.) will change once the ACA is fully implemented. However, practitioners' ability to defuse IRS worker reclassification efforts will be tested in the context of the ACA, particularly considering that two key issues under the health care law are the determination of employee status for purposes of computing individual employee coverage and the broader classification of an employer as a small or large employer.

Number of Employees Important

For purposes of administering and implementing the ACA, tax code Section 4980H has several important tests that are triggered by the number of employees employed by the business. The most well-known of these tests exempts employers from ACA penalties administered by the IRS if the number of full-time and/or full-time-equivalent employees employed by a single employer equals 50 or less. The decades-old question of whether a worker is an employee or an independent contractor has added significance due to this threshold test.

As under tax code provisions generally, the term ''employee'' under Section 4980H would mean a worker who is an employee under the common-law test.[1] Simi-

[1] Section 414(n), which treats ''leased employees,'' as defined in Section 414(n)(2), as employees of the service recipi-

 ISSN

larly, ''employer'' will mean the entity that is the employer of an employee under the common-law test. [2] Because these common law definitions are the same as those used for employment tax purposes and other benefit purposes, the SS-8 Units will almost certainly see an influx of determination requests from workers seeking to be reclassified to ensure benefits coverage. Although businesses and other service recipients have rarely initiated such SS-8 determinations in the past, these SS-8 units will likely experience an uptick in determination requests from service recipients who seek definitive resolution of the issue of whether the service recipient is a covered employer.

As indicated above, the practical effect or impact of these past adverse SS-8 determinations could almost always be defused or eliminated through a combination of legal arguments, relief provisions and planning opportunities. However, most of the techniques used to defuse employment tax liabilities will not be available to limit the ACA's applicability as they are specific to Subtitle C's employment tax provisions. Many of the personnel leading the IRS' implementation efforts have their backgrounds in the IRS Tax Exempt and Government Entities (TEGE) division with employment and worker classification responsibilities; therefore, we reasonably anticipate that personnel will bring their past focus on worker classification issues to the ACA's eligibility enforcement. Similarly, we anticipate that the SS-8 units' results-oriented determinations will also extend to the ACA worker classification determinations that are presented to the units for resolution of whether the workers are common law employees for ACA purposes.

What Test Will IRS Apply?

So what is the common law test that the IRS will apply? The remainder of this article will address the IRS test that I helped develop when I was one of the managers of one of the IRS branch of attorneys in TEGE with worker classification and employment tax responsibilities. The use of this test has expanded within TEGE and its counterparts within the IRS organizational structure.

Tax code 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 employee. The question of whether an individual is an independent contractor or an employee 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 Treasury Regulations; 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1 relating to the FICA, FUTA and federal income tax withholding on wages at source, respectively.

Section 31.3121(d)-1(c)(2) of the regulations provides, generally, that the relationship of employer and employee exists when the person for whom the services are performed has the right to direct and control the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done, but how it shall be done.

The 20-Factor Test

To determine this status, the so-called 20-factor common law test was developed by the Social Security Administration and the IRS. The 20 common law factors identified in Rev. Rul. 87-41 are designed only as guides, not absolute prerequisites, to determine whether an individual is an employee. The degree of importance of each of the factors is supposed to vary depending on the occupation and the factual context in which the services are performed. Rev. Rul. 87-41 advises that special scrutiny is required when applying the factors to assure that the formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement. Likewise, the courts have not always applied all 20 factors when examining a worker's status, choosing instead to focus on the factors that appear more relevant to a specific worker's status.

Unfortunately, IRS agents have applied the 20 factors in a mechanical method, even applying factors that had no relevance to a worker or the industry involved. The IRS recognizes the problems and inherent inequities of such a mechanical application. Therefore, leadership has advised agents to move away from rote, mechanical application. The Internal Revenue Manual was revised, and agents are advised: (1) the 20 factors are not always present in every case; (2) some factors do not apply to certain occupations; (3) the weight to be given to each factor is not always constant; and (4) the degree of importance of each factor may vary depending on the occupation.

Some of the traditional common law factors are specifically recognized as having ''lesser importance'' because work relationships change over time and because the courts were giving the factors little independent weight. Therefore, the IRS set out to create a more easily applied and equitable test and trained agents accordingly. IRS training materials caution agents to ''approach the issue of worker classification in a fair and impartial manner.''

As noted above, the relationship of employer and employee exists when the person for whom the services are performed has the right to control not only what is done, but also how it is done. The resulting IRS training materials focus on whether there is a right to direct or control how the worker performs the specific tasks for which he or she is hired, whether there is a right to direct or control how the financial aspects of the worker's activities are conducted, and how the parties perceive their relationship, provide evidence of the degree of control and autonomy, as well as the ability to recognize a profit or loss. Thus, the IRS has identified and maintained that evidence of control generally falls into three ''categories of evidence'':

- Behavioral Control

ent for various purposes, does not cross-reference § 4980H and accordingly would not apply to § 4980H.

[2] In addition, § 4980H provides that all entities treated as a single employer under § 414(b), (c), (m), or (o) are treated as a single employer for purposes of § 4980H. Section 4980H(c)(2)(C)(i). Thus, all employees of a controlled group under § 414(b) or (c), or an affiliated service group under § 414(m), are to be taken into account in determining whether any member of the controlled group or affiliated service group is an applicable large employer.

  ISSN

- Financial Control
- Relationship Factors

Behavioral Controls as the First Category of Evidence: Behavioral control includes factors such as training and instruction that substantiate the right to direct and control the details and means by which the worker performs the required services. Behavioral control refers to whether a company has the right to direct and control how the worker performs the task for which he or she was retained and includes the amount of training required and the amount and extent of instructions given to the worker regarding how, when, and where to perform the required tasks.

The IRS has historically recognized that virtually every business will impose instructions on workers, regardless of whether they are employees or independent contractors, and this often evidences itself in formal and informal training. The weight of the ''instructions'' depends on whether the instructions focus on how to get the job done rather than on the desired end result. Instructions on how to get the work done include the following:

- When to do the work;
- Where to do the work;
- What tools or equipment to use;
- What workers to hire to assist with the work;
- Where to purchase supplies or services;
- What work must be performed by a specified individual (including the ability to hire assistants);
- What routines or patterns to follow; and
- What order of sequence to follow.

Financial Controls as the Second Category of Evidence: Financial control includes economic factors such as significant investment, reimbursed expenses and other factors that demonstrate the worker's opportunity to realize a profit or a loss. Factors that illustrate financial controls and whether there is a right to direct and control the financial aspects of the worker's activities include:

- Whether the worker must make a significant investment to engage in the work;
- Whether the worker has unreimbursed expenses in connection with the work;
- Whether the worker's service is broadly available to the relevant market;
- Methods of payment; and
- The worker's opportunity for profit and loss.

Relationship of the Parties as the Third Category of Evidence: The relationship of the parties is an important factor because it reflects the parties' intent concerning control and demonstrates that the parties created the requisite independent contractor relationship. Relevant factors that indicate whether the parties intended an independent contractor relationship are derived from:

- The intent of the parties as expressed in written contracts;
- The provision of, or lack of, employee benefits;
- The right of the parties to terminate the relationship;
- The permanency of the relationship; and
- Whether the services performed are part of the service recipient's regular business activities.

Other factors that demonstrate the type of relationship between the parties include whether there exists a written contract describing the relationship the parties intended to create; whether the company provides the worker with employee-type benefits, such as health benefits, a pension plan, vacation pay or sick pay; and the permanency of the relationship.

Other Miscellaneous Factors: Other factors to consider in determining whether a worker is an employee or an independent contractor include whether the work is full-time or part-time, the place of work, and the hours of work.

As noted by the IRS Commissioner at the time, these internal IRS training materials were originally used ''to identify, simplify and clarify the relevant facts that should be evaluated in order to accurately determine worker classification under the common law.'' Subsequently, the IRS has updated and formally adopted these training materials and now incorporates them in the Internal Revenue Manual, in the IRS Form SS-8, IRS audits and, to a far lesser extent, in actual litigation.

These training materials should provide important insight into how the IRS intends agents to apply the common law tests in audits and SS-8 determinations. The training materials were certainly not intended to become a tool for arbitrarily and indiscriminately finding employee status, especially on an issue as important as health care and the ACA's implementation. Looking at the past applications by IRS personnel at all levels of the agency, but especially at the SS-8 units which will be on the front lines making determinations of employee status for eligibility and large employer determinations, significant concerns exist regarding how the test will be applied.

Will we see additional uptick in arbitrary determinations? Or will we see an application of the common law test in the training materials laid down by the IRS commissioner imploring IRS personnel to make ''fair and even-handed'' determinations? The answers to these questions may mean that Newport, Vt. becomes better known for its SS-8 determination unit rather than its quaint beauty, its ice-fishing festival and its summertime regattas on Lake Memphremagog.