Home Workers: Employee Status Hidden in Plain Sight

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The category of statutory employee is one of the least examined aspects of the debate over the characterization of independent contractors and employees. Wood and Karachale examine the home worker subset of this classification, which they argue needs attention in view of changing technologies.

There are many tests for determining who is an employee and who is not. Yet much of it comes down to the common law right to control, in which rules of agency are used to determine employee status.[1] The common law asks whether the person for whom services are performed has the right to control and direct the individual who performs the services, regarding not only the result but also the details and means of accomplishing the result.[2]

The IRS has developed its own 20-factor test based on the common law rules to determine employee status for federal income and employment tax purposes.[3] However, this 20-factor test provides no mechanical definition of an employee. There is no litmus test, no maximum or minimum number of factors pointing one way or another.

Rather, the entire situation and the special facts and circumstances of each case are supposed to govern the analysis. This holistic approach to employee status leaves much room for manipulation of the facts and produces irregular results. On whichever side of this Maginot Line you find yourself, it can be frustrating.

Take, for example, your worker Wanda. She works from home (or wherever she pleases), embroidering fancy designs on jeans. Although you provide the jeans and thread to Wanda and she returns the completed product to you, she receives no instructions, apart from some general specifications you require. She's a trained seamstress, and a creative spirit to boot. She provides her own needle and scissors, and she works when she pleases.

Wanda is paid based on the number of pairs of jeans she embroiders for you. The more she works, the greater her profit. Wanda works for others embroidering jeans and if she wants to stop working for you, she'll incur no liability. Based on the 20-part IRS test, most people might assume that Wanda is an independent contractor. Not so fast!

Statutory Employees

Given the fact-sensitive mishmash of factors that go into the employee versus independent contractor conundrum, some people are surprised to find that some workers are employees irrespective of whether they meet the common law definition of an employee. For over 50 years, the code has contained a codified class of workers, colloquially known as statutory employees, who are employees for employment tax purposes.[4] These workers include:

1. drivers who distribute beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who pick up and deliver laundry or dry cleaning;

2. full-time life insurance sales agents whose principal business activity is selling life insurance or annuity contracts;

3. individuals who work at home on materials or goods supplied by an employer that must be returned to the employer or his designate and for which the employer furnishes specifications regarding the work to be done; and

4. full-time traveling salespersons who solicit and transmit orders to an employer from wholesalers,

[1] *Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989).

[2] Reg. section 31.3121(d)-1(c)(2).

[3] Rev. Rul. 87-41, 1987-1 C.B. 296. More recently, the IRS has begun to use a three-part test: (1) behavioral controls, (2) financial controls, and (3) relationship of the parties. *See* the line of IRS administrative rulings including LTR 9843012 (July 20, 1998), *Doc 98-31382*, *98 TNT 206-54*; *see also* IRS Publication 15-A (2009) p. 6.

[4] Section 3121(d)(3).

retailers, contractors, or operators of hotels, restaurants, or other similar establishments.

Interestingly, these statutory employees are not true employees for all tax purposes. An employer must withhold Social Security and Medicare (FICA) taxes from the wages of statutory employees only if all three of the following conditions are met: (1) The contract of service contemplates that substantially all the services are to be performed personally by the individual, (2) the worker has no substantial investment in the facilities used in connection with the performance of the services, and (3) the services are part of a continuing relationship with the person for whom the services are performed and are not in the nature of a single transaction.[5]

Furthermore, no withholding of federal unemployment (FUTA) tax is required for two classes of statutory workers: full-time insurance salespeople and home workers. Finally, no federal income tax withholding is required from the wages of any of the statutory employees.[6]

Home Workers

Of these independent contractor/employee hybrids, the most interesting is the home worker. Let's fast-forward the example of our jean embroidery and bring Wanda into the 21st century. Suppose now that Wanda works for your Internet company, doing streaming video editing for your slick Web site. She still works from home, but now her work requires her to invest in expensive video editing software and a high-end computer. She works remotely using a virtual private network (VPN) to connect to your computer servers.

Although Wanda's work is now materially different from her work as an embroiderer, the IRS may still classify her as a home worker. It is not clear, however, that the home worker classification was intended to be so far-reaching. The legislative history of section 3121 describes home workers:

> Included within this occupational group are individuals who fabricate quilts, buttons, gloves, bedspreads, clothing, needle craft products, etc., or who address envelopes, off the premises of the person for whom such service is performed, under arrangements whereby they obtain from such person the materials or goods with respect to which they are to perform such service and are required to return the processed materials to such person or a person designated by him.[7]

The IRS's application of the home worker classification has begun to encompass far more workers than Congress probably intended. Given the growing tendency for independent contractors to work from home (or at least off-site) using telecommuting and Internet technologies, it is possible that many more workers will be classified as statutory employees.

Antiquated Rules and Statutory Shortcomings

The home worker classification has been applied to a wide variety of workers.[8] The IRS has typically classified garment workers as statutory employees of the home worker variety.[9] There is also a long line of IRS administrative materials in which workers performing secretarial work, typing work — and more recently computer work — have been deemed to be home workers.[10]

One problem with the static codification of the home worker designation is that it fails to account for recent technological changes. Two integral aspects of the home worker designation are that: (1) the worker makes no substantial investment in the facilities used in connection with the performance of the services,[11] and (2) the materials or goods on which the worker performs his services are furnished by the person for whom the services are performed and returned by the worker to that person.[12] The IRS is applying both these criteria in ways that do not account for recent technological and telecommuting changes that are ubiquitous in business today.

Substantial Investment

First, independent contractors working at home now often spend thousands of dollars on their computer equipment. Some independent contractors, such as technical or medical transcriptionists, may spend additional sums on equipment dedicated solely to their technical services. The IRS has ruled that the furnishing of a computer by the home worker, standing alone, does not constitute a substantial investment in facilities used in the work (because a computer may be used for purposes not related to the particular services).[13]

However, this analysis overlooks the very real fact that computer equipment now used by Web designers and computer programmers may constitute a substantial investment. Indeed, a federal district court in Texas has ruled just that. In *Lee v. United States*,[14] the court held that home workers who manufactured or assembled garments for a clothing manufacturer did have a substantial investment in facilities used in connection with the performance of their services and were therefore not employees for Social Security purposes.

In *Lee*, each pieceworker owned at least one indispensable piece of sewing equipment, a commercial grade

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[5]*See* IRS Publication 15-A (2009), p. 5.

[6]*See id.*

[7]H.R. Rep. No. 81-1300, 85th Cong., 1st Sess. (1949), 1950-2 C.B. 255, 287.

[8]Some of these are so specific as to be comical: *e.g.*, grading math exercises (LTR 5802112390A (Feb. 11, 1958)); salvaging hypodermic needles (LTR 6008102630A (Aug. 10, 1960)); tying fishing flies (LTR 6207268610A (July 26, 1962)); and removing insects from nests and sorting them (LTR 8110143 (Dec. 12, 1980)).

[9]*See* LTR 6308233110A (Aug. 23, 1963); LTR 6310102290A (Oct. 10, 1963); Rev. Rul. 72-88, 1972-1 C.B. 319; LTR 9511001 (Nov. 21, 1994), *95 TNT 54-17*.

[10]*See* Rev. Rul. 64-280, 1964-2 C.B. 384; Rev. Rul. 70-340, 1970-1 C.B. 202; LTR 8451004 (Aug. 1, 1984); LTR 9535002 (Mar. 29, 1995), *95 TNT 173-13*.

[11]Section 3121(D)(3) flush language; reg. section 31.3121(d)-1(d)(4)(i).

[12]Section 3121(D)(3)(C); reg. section 31.3121(d)-1(d)(1)(iii).

[13]LTR 8451004.

[14]870 F. Supp. 137 (W.D. Tex. 1994).

sewing machine, costing approximately $1,000. Most of the pieceworkers also owned a sew-serger, costing anywhere from $1,400 to $2,600. Some of the pieceworkers even owned a computerized sewing machine, costing approximately $2,400. The district court found that the cost of the equipment was clearly substantial as a matter of law.

The court in *Lee* appears to have recognized that increasingly sophisticated technology used by workers at home may require a substantial investment. For example, computer engineers and video programmers often perform services from home as independent contractors. They may use computer equipment that requires investments in the tens of thousands of dollars.

The home worker definition was intended to encompass workers making minimal investments in needles and thread — not computer programmers whose work requires investments in technology of thousands of dollars. Thus, if the IRS continues to apply its general rule that an investment in a computer is not substantial, it fails to take into consideration the very real and significant cost of equipment required of some workers to remain competitive in the computer and technology industries.

Receipt and Return of Materials and Goods

The second prerequisite to being classified as a home worker is that the worker must receive goods or materials from the employer on which services are performed, and then return the goods or materials to the employer. This requirement, applied literally, should not sweep into the statutory employee category many individuals working from home using VPN telecommuting technology.

Materials and goods are not defined by statute or regulation, but the Tax Court recently offered an interpretation. Unfortunately, its wooden analysis fails to address the questions that modern electronic communications create.

In *Vanzant v. Commissioner*,[15] the Tax Court assessed the home worker status of an educational consultant who collected data from different schools, input the data onto a ''software template'' supplied by the employer, and later e-mailed the template back to the employer. The court acknowledged that there is no guidance on the definition of materials or goods and therefore resorted to the dictionary.

According to the *American Heritage Dictionary*, materials are the ''tools or apparatus for the performance of a given task.''[16] The court said the taxpayer was required to use the software template to perform her duties. Thus, the software template was considered a material.

The Tax Court's failure to articulate a more developed analysis is unfortunate. Technology today clearly allows workers to perform their tasks remotely, while never actually receiving tangible goods or materials from an employer, and never actually returning goods or materials. For example, a VPN allows an off-site worker to access electronic information stored on an employer's servers. As a result, the employer never ''furnishes'' the information to the worker.

Rather, these data physically remain on the servers of the employer at the employer's place of business (or server location). The worker simply manipulates the information remotely. That means the worker never ''returns'' the goods or materials to the employer either. The worker is effectively performing services as though he were actually at the employer's site. (Of course, that analysis by itself may suggest the worker would be an employee under the traditional 20-factor test, but that is a separate question.)

Often, the lone material or good an employer may supply to a worker using a VPN is the code or a portable key fob allowing the worker access to the server. However, the worker does not return this code or key fob as part of the completed work. That makes the situation distinguishable from the situation in *Vanzant*, in which the worker returned the software template as part of her piecework.

Furthermore, in the typical modern telecommuting situation, the worker returns nothing to the employer that is even remotely analogous to the tangible objects — quilts, gloves, bedspreads, or envelopes — contemplated in the legislative history to the home worker provision.[17]

In sum, the technological advances available to workers working with computers and their remote access capabilities have created a working relationship that seems at odds with the home worker nomenclature. Indeed, many workers using secure remote access technology should arguably not meet the statutory definition of a home worker. At the very least, the dynamic has changed — and is continuing to evolve — dramatically.

The problem, it appears, is that the IRS is trying to assess these workers using criteria that are nearly 50 years old. Perhaps that is not the Service's fault, but it is not the fault of the workers or of the companies paying them either. The changing technology used by off-site workers means that these workers simply do not receive goods or materials and return them after performing services on them.

Conclusion

There are many factors that may validly demonstrate that an individual telecommuting from home is a home worker. However, a modern video programmer such as Wanda probably shouldn't be a statutory home worker. First, the IRS should reassess whether the furnishing of a computer and other technology, by itself, can never be a substantial investment. The financial investment in equipment required of some independent contractors in the technology sector is often substantial in a very literal sense. Besides, ''substantial'' is a relative term subject to much flexibility.

Second, the IRS and courts should carefully apply the literal requirement that home workers receive and return goods or materials. Without satisfying this condition, the

[15]T.C. Summ. Op. 2007-195, *Doc 2007-25748*, *2007 TNT 224-10*.

[16]1079 (4th ed. 2006).

[17]H.R. Rep. No. 81-1300, 85th Cong., 1st Sess. (1949), 1950-2 C.B. 255, 287.

worker simply cannot be a home worker. Today, many workers denominated as independent contractors in the technology field never actually receive or return tangible physical goods on which they have performed any services. Advances in computer technology and telecommuting may mean that these workers simply do not meet the statutory definition of a home worker.

Of course, apart from the home worker issue, one must confront the question whether the worker meets the common law criteria, which requires the use of the Service's 20 factors, or at least the three the agency has focused on recently: behavioral controls, financial controls, and relationship.[18] Even setting aside the statutory employee home worker canard, there are (with apologies to Robert Frost) miles to go before you sleep.

[18]*See* IRS Publication 15-A (2009), p. 6.