OREGON STATE BAR

Taxation Section

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Oregon's Independent Contractor Statutes: Time for Change

*By C. Jeffrey Abbott**

Defining the relationship between a worker and a business is tough enough under one set of guidelines. However, Oregon businesses are placed in a position of assessing whether a worker is an employee or independent contractor under two different sets of rules, one for the State of Oregon and the other for federal purposes. Most small businesses fail to recognize that Oregon uses quite a different definition for employment tax and workers' compensation purposes. In many cases, the Oregon rules yield opposite conclusions from a federal determination. This article will outline generally the rules for each, highlight their differences, recommend some changes to bring the two sets of rules closer together, and make some planning suggestions for Oregon businesses who currently use independent contractors.

Federal Law

Defining the relationship of a worker and a business under federal rules alone can be challenging. A Federal moratorium on new laws defining the relationship is in existence, so that the existing guidelines of Revenue Ruling 87-41 govern the analysis. Revenue Ruling 87-41 states that:

"the relationship of employer and employee exists when the person or persons for whom the services are performed have the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so."

After prefacing its objective with the above statements, the ruling follows with the infamous 20-factor test used by agents and advisors today to assist in a determination of a worker's status as a common law employee or independent contractor for federal employment tax purposes. A shortened checklist version of the 20-factor test follows:

1. Instructions regarding when, where, and how to work.
2. Training by persons hiring.
3. Integration of worker's services into business.
4. Services rendered personally by worker.
5. Hiring, supervising, and paying assistants by employer.
6. Continuing relationship between worker and hirer (even recurring but irregular).
7. Set hours of work by hirer.
8. Full time required by hirer (restricts worker from doing other gainful work).
9. Working on employer's premises—especially if work could be done elsewhere.
10. Order or sequence set by employer (or right to do so retained by employer).
11. Oral or written reports required by employer.
12. Payment by the hour, week, or month.
13. Payment of business and/or travel expenses by employer.
14. Furnishing of tools and materials (employer furnishes significant tools and materials).
15. Significant investment in facilities by worker.
16. Realization of profit or loss by worker (is worker subject to real risk of economic loss?).
17. Working for more than one firm at a time.
18. Making services available to general public (on a regular and consistent basis).
19. Right to discharge by employer.
20. Right to terminate by worker without liability.

In this analysis, no one factor is determinative. The facts and circumstances of each situation dictate the significance of a particular factor, and in some situations not all factors will apply. Given the variety of types of workers, this approach makes sense.

The Code also creates two special categories of workers. These two categories are i) statutory employees and ii) statutory non-employees. Statutory employees are treated as employees regardless of whether they are employees under common law rules. Statutory non-employees are not treated as employees regardless of their relationship with the business. This article will not address these narrow classifications.

Oregon Law

The Oregon classification of a worker as an employee or independent contractor is controlled by ORS 670.600. Unemployment taxes, workers' compensation and state tax withholding requirements all refer to this statute.

The Oregon statutory approach differs significantly from the federal methodology of Revenue Ruling 87-41. Whereas Revenue Ruling 87-41 requires a variety of factors to be weighed according to the facts and circumstances of the situation, Oregon's recipe requires that each of eight conditions be satisfied to reach a conclusion that an independent contractor relationship exists.[1]

To pass the independent contractor test in Oregon, ORS 670.600 requires that:

1. The worker be free from direction and control over the means and manner of providing the labor of services, except that the desired results may be specified;
2. The worker be responsible for all appropriate licensing;
3. Tools be furnished by the worker;
4. The worker have authority to hire and fire employees to perform the work;
5. Payment be made at completion of the project or at specific portions of the project or by retainer;
6. If licensure is required, the worker must be licensed;
7. If the worker provided services as an independent contractor in the previous year, the worker filed appropriate tax returns in the name of the business on a business form schedule;
8. The worker represent to the public that labor or services are to be provided by an independently established business.

In order to establish that requirement (8) is met, at least four of the following circumstances must exist:

a. The labor or services are carried out somewhere other than the worker's residence, or if in the residence, at a specific portion of the residence set aside for the business;

b . Business advertising or cards are purchased, or there is a trade association membership;

c . There is a separate telephone listing from the personal listing;

d. Only written contracts are used;

e. Labor or services are performed for two or more different people during the year; or

f. Through insurance or similar agreement, the worker assumes financial responsibility for the services or labor to be performed.

Problems of State Approach

The differences in the federal rules and Oregon approaches to worker classification create a trap for the unwary business and advisor. In many cases, neither the advisor nor the business is aware that there is a separate test for Oregon. Even if they are aware, they may assume that the tests will yield similar results. As a practical matter, because the Oregon test is so difficult to meet, the result will often be that a worker is an independent contractor for federal purposes yet an employee for state purposes.

This has important ramifications for both the business and the worker in reporting, tax withholding and payment and even workers' compensation. (In fact, these issues often come to light when a worker files for unemployment insurance compensation. When the worker lists a business as an employer, but there is no record of wages paid for that worker, the inquiries begin.)

The following chart summarizes the treatment of a worker with such a schizophrenic classification, and these are described below:

	Federal: Independent Contractor	**State: Employee**
Business	Return: 1099 Withholding: None Unemployment Tax: None	Return: W-2 Withholding: state income tax Unemployment Tax: Required
Worker	Return: Schedule C Taxes: Self Employment	Return: No Schedule C; expenses on Schedule A (2% floor)
	*Retirement Plan—not included in company plan *No workers' comp	*Retirement Plan—?? *Workers' Comp

Tax Returns:

The business would file a federal 1099, but a W-2 for state purposes only. From the worker's point of view, things are even trickier. For federal purposes, the worker files a Schedule C, but for state purposes amounts received are treated as wages. Expenses would be deductible for state purposes only to the extent they exceeded 2% of the worker's AGI.

Taxes and Withholding:

For federal purposes, the business would not withhold and pay over any federal income tax or federal employment taxes (FICA; FUTA; Medicare). The worker would have to pay federal self-employment taxes attributable to self-employment income. For state purposes, however, the business would have to withhold and pay over state income tax. For the business, failure to do so can result in significant exposure to penalties and interest.

Retirement Plans:

In this situation, the business does not generally include the worker in its retirement plan. If the worker maintains his or her own plan, contributions would presumably not be deductible for state income tax purposes, resulting in potential additional taxes, penalties and interest for the worker.

Workers' Compensation:

If the worker is an employee for state purposes, the business must cover the worker under the workers' compensation system. Failure to do so may result in the business being liable for the cost of the injury to the worker, back premiums and penalties for noncompliance.

Technical Problems of Oregon approach

There are a number of technical problems with Oregon's approach. For example, requirement (7) raises two significant problems. First, the manner in which a tax return is filed has very little, if any, bearing on whether the relationship between the worker and the business is that of an employee or an independent contractor. Second, when a worker appears to meet every other test of an independent contractor, but fails to file a certain tax return form or does not file a tax return at all, the hiring business is penalized, while the wrongdoer may likely be the worker. A difficulty with this condition is that it is a requirement applicable to the worker; the hiring business itself has no control over whether the individual has filed, or will file, a Schedule C.

Similar problems arise with the "multiple-choice" approach of requirement (8). For instance, the first of the six factors provides that for workers who work from home, the labor or services must be carried out in a specific portion of the residence which is a set aside location for the business. ORS 680.600(8)(A). Under this test, an attorney working in an area of his or her home not generally set aside for an office may be an employee of a person hiring his or her services. A business ordinarily will not know whether a person working out at home has set aside a room for the work or chooses to work from the kitchen table. Certainly, the relationship between the worker and the business is not affected by the location of the work if performed at other than the business location.

The second factor of requirement (8) provides that commercial advertising or business cards must be purchased for the business, or the individual or business entity have a trade association membership. This requirement also fails to focus on the issue of the relationship between the worker and the business. It falls short of recognizing today's high tech marketing strategies such as the world wide web, video tape and compact disk. Some professions use brochures, samples of their work, photographs or resumes. The third factor requires that a telephone listing and service be used for the business that is separate from the residence listing. Certainly, these last two factors can be easily cured by purchasing business cards or obtaining a cell phone, but the fact is that these two factors appear to have no direct relationship in determining whether a person is free from the direction and control and the means and manner of providing labor or services.

The use of a verbal contract will cause a business to fail to satisfy the fourth factor under ORS 670.600(8) where the relationship between a worker and the business must be documented under a written contract. The fifth factor of (8) requires that a worker must work for two or more different persons within one year. On its face, this factor appears somewhat reasonable. However, because of the application and interpretation by the State, this particular factor has been difficult to sustain in a number of instances. Carpet layers and cleaners who receive referrals from one or two business and perform services for many customers fail to pass this test according to the State. A business providing temporary worker referrals is likely considered an employer of the worker. The worker must also provide evidence of assuming financial responsibility for defective

workmanship or services not provided. The sixth factor, requires the worker to have warranties, errors and omissions insurance and/or performance bonds in order to prove the worker has assumed the risk of providing satisfactory services.

Certainly, ORS 670.600(8) appears to focus on the worker's ability to have dealt with certain business operational details, finances, marketing, (business cards and advertising) as well as requiring a worker to pay for and have a separate work location from home. Today's work environment, technology, and consulting agreements with workers have left ORS 670.600(8) in the past. The tests of that statute appear to be arbitrary in failing to focus on the relationship of the worker and the business. In addition, these tests focus on the worker's actions without any control by the business over those actions.

Procedural Problems

Finally, there are procedural problems with Oregon's approach. Section 530 is a federal law relief provision for businesses having treated workers as independent contractors. It is not part of the Internal Revenue Code, but was enacted as part of the 1978 Revenue Act. It allows businesses to treat workers as independent contractors even though the worker may not actually qualify as an independent contractor, if certain conditions are met.

Where a worker would be otherwise classified as an employee for federal employment tax purposes (Social Security, unemployment tax, and income tax withholding), section 530 allows an employer to treat the worker as independent contractor rather than as an employee. Thus, the employer is not liable for any employment taxes with respect to the worker's income, both retroactively and prospectively. In addition, the worker is not liable for self-employment tax (employee and employer share of Social Security tax and Medicare tax), but rather is only liable for the employee's share of Social Security and Medicare tax (approximately one-half of that the would otherwise be due in self-employment taxes).

Section 530 relief is available only under specific conditions. A business is entitled to treat an individual as an independent contractor, as opposed to an employee, if: (1) the business has not treated the worker as an employee, generally, for any period; (2) the business has not treated any other worker in a similar position as an employee for purposes of employment taxes for any period; (3) the business has filed appropriate federal tax returns on a basis consistent with its treatment of a worker as an independent contractor; and (4) the business has a reasonable basis for not treating the individual as an employee.

Oregon has no statutory or administrative equivalent to Section 530. Where a business is afforded section 530 relief, it still may have to treat the worker as an employee for state unemployment taxes, income tax withholding and workers' compensation. Again the reporting requirements become problematic for the business under the state rules. Federal reporting requirements under section 530 simply requires a form 1099 for services rendered. Oregon would presumably require a W-2 and unemployment tax be paid on the payments to the worker.

Time For A Change

The difference in approach between the federal and state worker classification schemes frustrates both clients and their advisors. The less well known state rules become a trap for the unwary, and can lead to the absurd result described above in which the same worker is treated as an employee by the state but an independent contractor by the federal government.

Which is the better approach to properly identifying workers? Certainly the federal approach is more complicated than the Oregon approach, requiring a balancing and blending of 20 factors. The Oregon approach is arguably more easily administered. Practitioners are likely to favor the federal approach, which provides greater latitude for interpretation, advocacy, and planning; their enforcement colleagues would probably prefer the Oregon checklist approach. But, fundamentally, the Oregon approach is flawed because of its rigidity: it chooses to focus on arbitrary factors, regardless of the particular facts, rather than examining the totality of the parties' relationship. It does not take into account the wide variety of situations in which workers and businesses actually operate, as does the federal approach.

Therefore, a welcome change would be to bring Oregon's approach in line with the federal approach of Revenue Ruling 87-41, for both tax

and workers' compensation purposes. In addition, providing a procedure for providing relief similar to that of Section 530 would be appropriate to protect businesses in situations in which long time industry practice is to treat workers as independent contractors.

Planning Suggestions

What should advisors tell their clients that use independent contractors and may have difficulty passing the Oregon statutory test under ORS 670.600? First, an advisor should screen the client's factual circumstances to determine the potential risk of loss under the workers' compensation issues, state income tax withholding and unemployment tax issues. A business without a workers' compensation policy that has a loss to a presumed independent contractor may be deemed a non-complying employer and therefore subject to the costs of the injury as well as penalties and premiums. The state income tax withholding rules and potential penalties could create a sizable risk to employers, depending on the amounts paid to workers presumed to be independent contractors.

A business that does not want to treat its independent contractors as employees for state purposes may wish to beef up its contracts. They should be in writing, of course, and include provisions that affirm, from the worker's point of view, that the statutory requirements of ORS 670.600 are met. Although the affirmation by the worker is no assurance that the particular requirement has been met or performed by the worker, it should certainly add credence to the argument that the responsibility was the worker's, not the business'; whether or not the worker actually followed through. This could include affirmations that the worker has the proper licensing required by state and local law. The business might require that evidence or photocopies of those licenses be attached to the contract. Certainly, the structure of the agreement and the work could be tailored around ORS 670.600. The method of payment could be restructured and drafted in such a way as to make payment on completion of the performance of the service. The contract could require evidence that the worker, if in business the prior year, provide a copy of the Schedule C of the worker or an affirmation that a Schedule C was filed in the previous year. Each independent contractor should supply a copy of its business card to be kept on file. Where possible, the worker should provide the tools necessary to provide the service. A contract could be structured in such a way as to provide a checklist of items that are consistent with the requirements of ORS 670.600 and have the worker sign off on each of the requirements. These kinds of affirmations are no guarantee that the requirements are in fact satisfied, but should benefit the client in an audit situation.

* Abbott & Associates, PC, West Linn

1 The courts agree that all eight factors must be met. Liberty Northwest Ins. Corp. v. Potts, 119 Or.App. 252, 850 P2d 1135 (1993).

2002 OREGON TAX INSTITUTE

This year's Oregon Tax Institute will be held on **September 27-28** at the Governor Hotel in Portland. The new time and location will make the conference more convenient for our members.

The program will follow the same general format as in past years - a full day on Friday and a half day on Saturday. We will have a mix of national level and local speakers, and a combination of lead presentations and breakout sessions. Presently confirmed speakers are: Stef Tucker, on 1031 Exchanges; Steve Frost, on Equity Based Compensation in LLCs; and Joel Kuntz on S Corporations. Other nationally known speakers have also been invited.

All participants will be invited to a hosted affair on Friday night at the historic Pittock Mansion. The beautiful building, grounds and view will be accompanied by excellent food, a jazz band, and three premier Oregon winemakers pouring their current release wines throughout the evening. Bring your companions!

New this year will be a ticket that will allow lawyers within a single firm to share their registration for a small additional fee. This will allow a group to allocate individual presentations to the lawyers who will most benefit.

The Section's Executive Committee and the Institute's Planning Committee are very excited to continue our new tradition of presenting a first-class educational event in a relaxed and fun setting. We hope that you will be able to attend.

LEGISLATIVE UPDATE

*By Karey A. Schoenfeld**

Although the Oregon Legislature does not meet for quite some time, the Tax Section has been looking at a couple of tax issues in preparation for the upcoming legislative session. We have been working together with many other groups of the Oregon State Bar on a proposal to adopt community property law in Oregon. In addition, we are drafting proposed legislation to clarify the definition of an employee versus independent contractor for unemployment tax purposes.

Uniform Marital Property Act

The Oregon Law Commission ("Commission") proposed legislation which would essentially convert Oregon to a community property state. The discussion originated in an attempt to equalize the treatment of a married couple in the event of either death or divorce. Currently, an individual can prevent a spouse from receiving any portion of their estate by placing all assets in a revocable trust. Although Oregon has an elective share statute, a surviving spouse is entitled to one-fourth of the probate estate of their deceased spouse. This would not include assets passing under a revocable trust.

In contrast, a couple that divorces would be in a much different situation. The courts look to a just and equitable division of the property, and in long-term marriages each spouse is often entitled to 50% of all assets, whether held jointly or separately. The Commission was concerned that some attorneys were advising their clients to get divorced, rather than risk being excluded from their spouse's estate. In analyzing the various options to address the forced share issue, the Commission set forth a proposal to adopt a version of the Uniform Marital Property Act (UMPA). Although this might address the problems currently inherent in the elective share statute, there are concerns from various Sections of the Bar that the UMPA would have negative consequences on other areas of the law.

From a tax standpoint, the benefits of holding assets as community property are substantial upon the death of either spouse. Assets held as community property receive a full step-up in basis at the death of either party; whereas non-community property receives a step-up in basis of only the portion owned by the deceased spouse. While the full step-up is very beneficial, the Legislative Committee of the Tax Section is concerned about the non-tax consequences if our laws are changed mid-stream to community property. This is a concern voiced by most Sections which have been involved with the review of the proposed UMPA. While many feel that community property law may be preferable when starting from scratch, there is great concern about switching mid-stream to community property rules. For example, separate debts would suddenly become joint debts, without the knowledge of the spouses. Although parties could enter into agreements to maintain separate property, it would require proactive steps by the spouses.

Based on the input from the various sections of the Bar, the Commission dropped the proposal to adopt the UMPA, and will instead look at other ways to address the forced share issue. Due to the broad impact that the adoption of a UMPA or community property law would have on assets and liabilities of married couples, most Bar Sections had voiced opposition to the law. The Tax Section proposed that we pursue the use of an opt-in community property law, similar to that adopted in Alaska, to allow Oregonians to take advantage of the step-up in basis, but only if they do so knowingly, after considering the non-tax consequences. Due to timing, the Tax Section did not pursue the proposal.

Employee vs Independent Contractor

The Tax Section will propose legislation to try to correct what we perceive to be inequities in Oregon unemployment tax laws. For an analysis of the issue, see the article in this issue titled "Oregon's Independent Contractor Statutes: Time for Change."

* Ferguson & Schoenfeld, PLLC, Vancouver, Washington

Upcoming Tax Meetings

PORTLAND:

Portland Luncheon Series
Contact: Lewis Horowitz, horowitzl@lanepowell.com

June 23, 2002
Recent Development Relating to Tax Deferred Exchanges
Speaker: Larry Brant

July 10, 2002
Roundtable (601 SW 2nd, Suite 2100) – "Tax Issues on Our Respective Tables—Bring your thorniest tax question for the group to address"

Portland Tax Forum
Contact: Mark Golding (503) 222-1812
mgolding@hagendye.com

June 14, 2002
Workouts and Debt Restructuring
Speaker: Fred Witt

SALEM:

Salem Luncheon Series
Contact: David Roth, droth@heltzel.com

July 16, 2002
Defined Contribution Retirement Plan Update
Speaker: Randy Cook and David Roth

EUGENE:

Eugene-Springfield Tax Association
Conta ct: Miles "Spike" Joseph
spike@cbcpa.com

(No meetings scheduled in June, July, August)

Don't forget the Oregon Tax Institute
September 27-28, Portland, Oregon

Watch your mail for registration details.

Presorted Standard
US Postage Paid
Portland, Oregon
Permit No. 341

Oregon State Bar
Taxation Section
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Lake Oswego, OR 97035

From the Editor:

We welcome your contributions to, and suggestions for, the newsletter. To submit an article, please call or email me with your idea rather than sending the article along first. If you have ideas for ongoing columns, let me know.

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Editors note: *Articles included in this newsletter are informational only and should not be construed as providing legal advice. For legal advice please consult the author of the article or your own tax advisor.*