



## Market Segment Specialization Program



# Business Consultants

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown Webster's Dictionary or from a list of names of counties in the United States as listed in the United States Government Printing Office Style Manual.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.



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## Business Consultants

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## OBJECTIVES

Upon completion of this audit techniques guide, the examiner will be able to:

1. Identify and develop issues frequent and/or unique to the market segment.
2. Conduct an examination consistent with other market segment examinations throughout the Service.

### Other Required Material

You will need to obtain a copy of Publication 1976 (09/1996), *Independent Contractor or Employee?* IRS Catalog Number 22927M.

The public can order this IRS Publication by calling 1-800-829-3676.

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# Market Segment Definition and Overview

## INTRODUCTION

Business Consulting is one of the fastest growing industries in the world today. This trend is a result of many changes occurring in the world economy. During the past two decades, the business community has been downsizing which has caused displacement of many workers. These displaced workers have created a growing industry now known as "consulting". Some of these former employees are now contractors who are engaged by the same company and/or industry which previously employed them.

## MARKET SEGMENT DEFINITION

What is "consulting"? The dictionary defines consulting as being employed in giving professional advice, either to the public or to those practicing a profession. Treasury Regulation section 1.448-1T(e)(4)(IV) defines the field of consulting as "the provision of advice and counsel," but exclude sales and brokerage services, "or economically similar services." The distinction between the two is based on the facts and circumstances, but a significant factor is whether the taxpayer's compensation is contingent on the outcome of a particular transaction. Thus an economic analyst, data processing consultant, management consultant, or financial planner is performing "consulting" activities; while a securities broker, computer sales agent, recruiter, advertising agent, or insurance broker is not, although these activities may include some element of "advice and counsel."

Consulting in the practical sense can be anything. It is a common buzzword in the business world. Many people call themselves a consultant, when in reality they may be a broker, a salesperson, a retailer or engaged in a business which is a hybrid. One of the issues facing the industry is an influx of new entrants, many of them managers and executives who have been downsized. They open up shop independently or in collaboration with others. For many displaced workers, consulting is something they say they are doing in the interim while searching for a job. The Bureau of Labor Statistics estimates 8.5 million people worked as independent contractors, independent consultants, or free-lance workers, accounting for 6.7 percent of all U.S. workers in their Current Population Survey (CPS). There are an estimated 5 million home-based workers who called themselves consultants. However, the National Bureau of Professional Management Consultants reported that 70 percent of new consultants drop out in the first year.

Most professions can support a consultant. Consultants find a niche in an industry and provide services within that niche. See Exhibit A for the CPS breakdown of industries and occupations in which independent contractors, independent consultants, or free-lance workers are employed. Consultants are problem

solvers. Most consultants have the ability to decipher a problem and find a solution which they present to their client. Some examples of the fields in which consultants work include:

Accounting	Fund raising
Advertising	Import/Export
Aerospace	Information management
Agriculture/farming	Insurance
Arbitration	Labor relations
Auditing	Litigation
Aviation	Management
Business and business planning	Marketing
Career and vocational counselors	Organizational development
Communications	Personnel
Construction projects	Political
Convention and conference	Public Relations
Meeting planning	Public Speaking
Customer Service	Safety
Data Processing	Sales management/promotion
Engineering	Security
Financial management	Taxes
	Training

The consulting industry is very broad and does not have an overall regulatory body or specific licensing guidelines. However, some consultants hold degrees, certifications or a professional license within the industry that they work. Consulting is a way of doing business within a particular industry. In general, most of the industry consultants are compensated under a "pay as you go" system. However, contingency fees are a new development in the way some large firms are billing. In these "value based arrangements," the consultant makes the upfront investment in work and doesn't charge the client until the promised benefits are realized.

Since the industry is so diverse, consultants may be able to find guidance in their area of expertise within a consulting association specific to their profession. See Exhibit B for a sample of the various associations available in the United States.

## **COMMON PRACTICES**

Consultants commonly use a "rolodex" system and strategic alliances in order to fulfill their contracts. A "rolodex" system is a collection of companies and/or other individuals with different expertise that a person can refer to in order to obtain various services needed by their company. Normally, there is an informal agreement to make use of each other's services whenever possible. A strategic alliance is an affiliation with other companies whose expertise varies from their own. This is done with the intent of providing full service to a client. Each

affiliate works as a member of a team to fulfill the requirements of a contract. (Thus, these alliances can provide one stop shopping for a client and act as a virtual company.)

## **RETURNS EXAMINED**

This audit techniques guide is based on examinations of sole proprietors, corporations and partnerships completed by Revenue Agents. Background information was obtained from published books and periodicals.

## **INTERNAL CONTROL**

As part of every examination, the examiner needs to evaluate and document the internal control of the business. This is very important in determining the agent's level of reliance on the taxpayer's books and records for the scope and depth of the examination. See Exhibit C for a sample questionnaire.

## **CONCLUSION**

The explosion of the consulting industry is a change in how business is done in a global economy. This audit techniques guide is a tool to be used by examiners to assist in identifying frequent and unique issues associated with the business consulting industry.

This guide is set up to provide the examiner information on each potential issue that may arise in an audit within this industry. Each issue includes an introduction to the issue, pre-audit suggestions, audit techniques to assist in the issue and a law section describing the legal background for each issue.

# POTENTIAL ISSUES

## TRAVEL

### Introduction

There is extensive travel inside and outside the United States within the consulting field. This industry lends itself to significant travel because many consultants have a specialized niche and a broad geographical client base.

Potential areas of concern:

1. Spousal/Family travel
2. Personal travel, particularly out of the United States

### Pre-Audit

When an examiner is performing a pre-audit analysis, he or she should expect to see a separate line item for travel. If no travel expense is reflected on the return, the examiner may want to follow-up to determine if travel expense may be incorrectly characterized on the return. The taxpayer may fail to allocate between the personal and business nature of the expense, as required under Internal Revenue Code section 274. The examiner will also need to prepare pertinent interview questions and request specific documentation on the Information Document Request. See Exhibits D and E.

### Audit Techniques

A thorough interview is very important to find out where the taxpayer's client base is located and how often the taxpayer travels. The examiner should be alert to companion/family travel in and outside of the United States. The examiner can focus on extended travel beyond the actual business purpose and companion travel by testing the large, unusual or questionable items and sampling a time frame (i.e. 1 month).

### Law

To be deductible under IRC section 162(a)(2), an employee's traveling expense must be: (1) ordinary and necessary, (2) incurred in pursuit of a trade or business, and (3) incurred while away from home. *Commissioner v. Flowers*, 326 U.S. 465 (1946), 1946-1 C.B. 57.

An employee's tax home is generally considered to be located at, or in the vicinity of, the employee's regular (or principal if more than one regular) place of business; while performing services there, an employee may not deduct the cost of meals and lodging, even if the employee maintains a permanent residence elsewhere. Rev. Rul. 93-86, 1993-2 C.B. 71; Rev. Rul. 75-432, 1975-2 C.B. 60; Rev. Rul. 60-189, 1960-1 C.B. 60.

If the employee has no regular or principal place of business, the employee's tax home is the employee's "abode in a real and substantial sense." If the employee has neither a regular or principal place of business, nor an abode in a real and substantial sense, the employee is an itinerant and effectively is never away from home. Rev. Rul. 73-529, 1973-2 C.B. 37; Rev. Rul. 71-247, 1971-1 C.B. 54; Rev. Rul. 60-189.

If the employee has two or more regular places of business, the tax home is located at the principal place of business. Rev. Rul. 93-86; Rev. Rul. 75-432; *Markey v. Commissioner*, 490 F.2d 1249 (6<sup>th</sup> Cir. 1974). Thus, expenses of travel incurred while discharging duties at a location that is removed from the principal post of duty (i.e., incurred at the non-principal place of business) are deductible if the other requirements of IRC section 162(a)(2) are met. The location of an employee's principal place of business is a question of fact; important factors include: total time ordinarily spent at each of the business posts, the degree of business activity at each post, and whether the financial return with respect to each post is significant or insignificant. Rev. Rul. 54-147, 1954-1 C.B. 51.

The employee is treated as being "away from home" during any period of employment at a single location only if the employment is temporary. Rev. Rul. 93-86. For this purpose, employment that is realistically expected to last for 1 year or less, based on an objective determination at the time employment is begun, is treated as temporary (in the absence of facts or circumstances indicating otherwise). However, an indefinite or regular work location does not necessarily become temporary because of brief and infrequent work assignments to other locations. *Blatnick v. Commissioner*, 56 T.C. 1344 (1971). Finally, an employee is not "away from home" unless the employee is at the assigned work location long enough to require an overnight stay. *United States v. Correll*, 389 U.S. 299 (1967), 1968-1 C.B. 64.

IRC section 274(d) provides that no deduction shall be allowed under IRC sections 162 or 212 for any expenditure away from home unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his or her own statement the amount, time, place and business purpose of the expenditure. IRC section 274 and Treas. Reg. sections 1.274-5T(c)(1) and 1.274-5A(c)(1) require that the elements of any expenditure must be recorded "at or near the time" when the expense was incurred. Although not required, these sections contemplate that the taxpayer will maintain a diary, travel log, trip sheet, or

similar documentation while the taxpayer has current knowledge of the travel expenditure. The taxpayer may rely on "other sufficient evidence", but that evidence must be as specific and detailed as to the elements of the expense as the "adequate records provision."

IRC section 274(c) provides rules for the substantiation of foreign travel. For travel outside the United States that is entirely in pursuit of a trade or business, the entire amount of expenses incurred are deductible. However, if a portion of travel is for nonbusiness activities, the taxpayer must allocate her/his travel expenses between personal nondeductible costs and deductible business expenses. No such allocation is required if less than 25 percent of the time spent outside the United States was for nonbusiness activities of the taxpayer.

IRC section 274(m)(3), effective for taxable years after 1993, disallows the deduction of travel expenses incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer unless that individual is an employee of the taxpayer who is traveling for a bona fide business purpose, whose expenses would otherwise be deductible.

Note well that there are also special rules in IRC section 274(m)(1)(A) for luxury water transportation and under IRC section 274(h) for conventions or seminars held outside of North America or on a cruise ship.

## Research Materials

Below list is not designed to be all-inclusive.

- *Charron v United States*, 97-2 USTC □ 50,852
- *Pasharikoff v Commissioner*, TCM 1997-208
- Revenue Ruling 79-425, 1979-2 CB 81
- Revenue Ruling 75-169, 1875-1 CB 59
- *Commissioner v. Flowers*, 326 U.S. 465 (1946), 1946-1 C.B. 57
- Rev. Rul. 93-86, 1993-2 C.B. 71
- Rev. Rul. 75-432, 1975-2 C.B. 60
- Rev. Rul. 60-189, 1960-1 C.B. 60
- Rev. Rul. 73-529, 1973-2 C.B. 37
- Rev. Rul. 71-247, 1971-1 C.B. 54
- *Markey v. Commissioner*, 490 F.2d 1249 (6<sup>th</sup> Cir. 1974)
- Rev. Rul. 54-147, 1954-1 C.B. 51
- *Blatnick v. Commissioner*, 56 T.C. 1344 (1971)
- *United States v. Correll*, 389 U.S. 299 (1967), 1968-1 C.B. 64

## **Uniform Issue Numbers**

- 274-03-00 - Traveling
- 274-08-00 – Substantiation
- 274-09-00 - Foreign Conventions
- 274-10-01 - In general
- 274-13-03 - Luxury Water Transportation
- 274-13-04 - Spousal Travel

## **INDEPENDENT CONTRACTOR VS. EMPLOYEE**

### **Introduction**

The independent contractor versus employee issue is prevalent in many industries. The consulting industry is no exception.

Potential areas of concern are:

1. A former employee coming back to a company as an independent consultant with a minimal break in service.
2. The continued use of the same strategic alliances.

The first potential issue has evolved due to the downsizing taking place in the business world over the past decade. Many employers, in an effort to lower costs, have terminated specialized employees and then hired them back as independent consultants. This allows the employer to lower their costs in payroll and employee benefits.

The second potential issue may arise when a consultant obtains a client for which they do not have all the resources themselves to fulfill the contract. To meet the needs of their client they form business relationships [strategic alliances or use of a "card catalog system"(see glossary of terms)] with other individuals. This can lead to an employee/employer relationship.

### **Pre-Audit**

First area of concern - During the pre-audit phase, this issue may not be apparent from the face of the return. If the return being examined is an individual return, the examiner will want to obtain IRPTRO from IDRS to determine the source of the gross receipts from consulting. The examiner will also want to prepare interview questions to address this potential area. See Exhibit E.

Second area of concern - When the examiner is reviewing the return during the pre-audit phase of the examination, the examiner needs to be alert to large

consulting or contract expenses, or expenses for other services. If the individual incurs significant unreimbursed expenses, this would be a factor in determining an employer/employee relationship. The examiner will want to prepare interview questions. See Exhibit E.

## **Audit Techniques**

When the examiner decides to pursue this issue, the first step is to determine if the individual has a safe haven as an employer under Section 530. The examiner must supply the individual with publication 1976 to assist him/her in this determination. See Exhibit G. See Exhibit H for a questionnaire/workpaper to aid the examiner in reaching a conclusion, as to whether, the individual meets the requirements for treatment under Section 530. If the individual does not qualify for the Section 530 relief, the examiner may go forward with the development of this issue.

First area of concern: This issue is a facts and circumstances issue. The examiner will need to analyze the individual's answers to the interview, as well as the contract (written or oral) between the individual and his or her major client to see if an employee/employer relationship exists. The examiner will want to be alert to behavioral control, financial control and the relationship of the parties. See Exhibit H for more details.

Second area of concern: This issue is also a facts and circumstances issue which the examiner will want to develop based upon behavioral control, financial control and the relationship of the parties. See Exhibit H for additional details.

## **Law**

Section 530 of the Revenue Act of 1978, provides relief for individuals involved in controversies over their employment status with the Internal Revenue Service. Section 530 is not part of the Internal Revenue Code, but may be found in Public Law 95-600 of the Revenue Act of 1978, 1978-3 C.B. 119. The purpose of Section 530 is to shield employers who had a reasonable basis for treating workers as independent contractors from employment tax consequences arising from employment status reclassification by the Service. (IRC section 530 deals with education individual retirement accounts.) Section 530 has been amended by subsequent legislation, specifically; section 1706 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 C.B. (Vol. 1) 1, 698, and section 1122 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 1996-3 C.B. 155, 166.

Section 530 should be addressed as early as practical where the employment status of a consultant is at issue exists. Discuss with the individual the reasons why he or she believes they were treated as either an independent contractor or as an employee. Failure to correct an individual's improper treatment of their

"employee" during an examination provides the taxpayer a "safe haven." Thus, it is important to correct employee status.

Section 530(a)(1) terminates an employer's liability for employment taxes under subtitle C, which includes FICA, FUTA, and income tax withholding, and any interest or penalties attributable to the liability for employment taxes. Section 530 provides that, for employment tax purposes, an individual will be deemed not to be an employee unless the employer had no reasonable basis for treating the individual as an independent contractor.

To qualify for relief under Section 530, an individual must meet three general requirements:

1. Required Forms Filed - All Federal tax returns required to be filed by the individual, with regards to the treatment of individuals as independent contractors, must be filed timely.
2. Consistent Treatment –
  - a. The treatment of an individual as an independent contractor must be consistent with the treatment by the employer of any individual holding a substantially similar position.
  - b. A substantially similar position exists when the job functions, duties, responsibilities, the party controlling functions, and the exercise of the duties and responsibilities are substantially similar.
3. Reasonable Basis - Reasonable basis is established under Section 530(a)(2) if the individual can show reasonable reliance on one of the following:
  - a. Judicial precedent, published ruling, technical advice with respect to the individual, or a ruling issued to the individual.
  - b. Reliance on a past Internal Revenue Service audit, if that audit entailed no assessment attributable to the individual's treatment of those holding positions substantially similar to that held by the individual whose treatment is at issue.
  - c. Reliance on a private letter ruling issued to the taxpayer to establish a reasonable basis under Section 530(a)(2).
  - d. A long-standing, recognized practice of a significant segment of the industry based on the geographical location in which the individual does business. For example, *in General Investment Corporation v. United States*, 823 F.2d 337 (9<sup>th</sup> Cir. 1987), the court held that a mining company had a reasonable basis for treating miners as independent contractors because the taxpayer had substantiated that the practice of treating miners as independent contractors was both long standing and well recognized within a significant segment of the local mining industry.

The determination of whether a consultant is an employee or independent contractor is a factual question to be determined upon the consideration of the facts and the circumstances and the application of the law and regulations to a particular case. See *Professional & Executive Leasing v. Commissioner*, 89 T.C.

225, 232 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988) and *Simpson v. Commissioner*, 64 T.C. 974, 984 (1975). Guides for determining a consultant's status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Federal income tax withholding, respectively.

In general, it should be noted that IRC section 3121(d)(2) requires the application of the common law rules in determining the employer-employee relationship. In determining whether an individual is an employee under the common law rules, the most important question is the amount of control the person or entity has over the individual hired to perform the services. This control question has been broken down into three areas of inquiry: 1) behavioral control; 2) financial control; and 3) relationship of the parties. Within these areas of inquiry, there are certain factors which indicate the level of control over the individual employed. These factors are set forth in Exhibit F.

These factors have been developed based on the examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and factual context in which the services are performed. See Rev. Rul. 87-41, 1987-1 C.B. 296. These factors are not to be applied mechanically as a scorecard, but are to be used as an aid in applying the common law rules. Having determined the relevant factors, consideration must be given to the relative weight of these factors in determining the consultant's status. The auditor will then need to weigh the facts and circumstances of each case and determine a consultant's status accordingly.

Determination of employee vs. independent contractor status is relevant with respect to the following federal tax issues: (1) whether an individual is liable for the employee's share of the FICA tax; (2) whether business expenses must be itemized and are subject to the 2 percent floor on miscellaneous itemized deductions of IRC section 67 or are subject to the adjusted gross income additions of IRC section 62(c) and the itemized deduction limitation of IRC section 68; (3) whether the firm's qualified pension plan must treat the individual as an employee for qualification purposes; and (4) whether the individual has a right to continuing health care coverage after termination for purposes of Consolidated Omnibus Reconciliation Act of 1986, P.L. 99-272 (COBRA). In addition, employee status is also relevant for purposes of determining coverage under or liability for workers' compensation benefits, federal and state civil rights laws, the Fair Labor Standards Act (regulating minimum wage and overtime pay), the national Labor Relations Act (providing employees with the right of collective bargaining), the Occupational Safety and Health Act (regulating safety in the workplace), and the Americans with Disabilities Act (requiring employers to make special accommodations for disabled employees).

For further assistance regarding employment tax issues, contact the employment tax coordinator. For further assistance regarding Section 530 issues, contact the Area Counsel offices or Employment Tax Branch 1 of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities).

## **Other Information**

The examiner should inquire about any Classification Settlement Programs available to the individual. See Chapter 6, Classification Settlement Program (CSP) of IRM 104.6, *Employment Tax Handbook*, for more information.

## **Research Materials**

Below list is not designed to be all-inclusive.

- Misc-Doc: Training Guide - Worker Classification
- Audit Technique Guide for Trucking Industry - Chapter 5
- ***Ren-Lyn Corporation v United States***, 97-1 USTC 50,385 [968 F.Supp 363 (N.D. Ohio 1997)]
- ***La Nails Inc. v United States***, 98-1 USTC 50,438
- Rev. Rul. 87-41, 1987-1 CB 296

## **Uniform Issue Numbers**

- 3121-05-00 Employer vs. not Employer
- 3121-04-01 Employee vs. non Employee

## **MEALS AND ENTERTAINMENT**

### **Introduction**

Given the considerable travel usually required in this industry, there may be a sizeable expense for meals/entertainment.

Potential areas of concern:

1. Personal (i.e.: lack of business purpose)
2. Is the applicable percentage limitation being applied properly (currently 50 percent limitation)
  - a. Travel status meals/entertainment should be limited if not being reimbursed by client.  
(See reimbursed expenses)
  - b. Meals/entertainment in non-travel status

## **Pre-Audit**

The examiner may want to pay particular attention to the limitation of meals and entertainment while in travel status (because many taxpayers are unaware that the limitation applies to meals while in travel status). If no meals/entertainment expense is reflected on the return, the examiner may want to follow-up to determine if the expense may be incorrectly categorized on the return. The taxpayer may have failed to apply the appropriate percentage limitation. During the pre-audit analysis, the examiner will want to prepare pertinent interview questions and request specific documentation on the Information Document Request. See Exhibits D and E.

## **Audit Techniques**

Sample to verify that the taxpayer is complying with IRC section 274. When the examiner reviews the sample, he or she should inspect for substantiation purposes, and verify that the taxpayer has properly applied the limitation to all unreimbursed meals and entertainment.

## **Law**

To deduct meal and entertainment expenses, the taxpayer must establish that the expense was one that was "ordinary and necessary" in carrying on his trade or business. IRC sections 162(a) or 212. The taxpayer must also show that the expense was either "directly related to" or "associated with" the active conduct of such trade or business. IRC section 274(a)(1)(A) and Treas. Reg. section 1.274-2(a).

IRC section 274(d) provides that no deduction shall be allowed under IRC section 162 or 212 for meal or entertainment expenses unless the taxpayer substantiates these expenses by adequate records or by sufficient evidence corroborating his or her own statement. To deduct such expenses, the taxpayer must record: 1) the amount of the expense and a description of each separate expenditure; 2) the time and place the entertainment or meal was provided; 3) the business purpose of the activity, including a description of any business benefit derived or expected; 4) the nature of the business discussion; and 5) the business relationship to the person or persons entertained.

IRC section 274 and Treas. Reg. sections 1.274-5T(c)(1) and 1.274-5A(c)(1) require that the elements of any expenditure be recorded "at or near the time" when the expense was incurred. Although not required, these sections contemplate that the taxpayer will maintain a diary, travel log, or similar documentation while the taxpayer has current knowledge of the travel expenditure. The taxpayer may rely on "other sufficient evidence," but that

evidence must be as specific and detailed as to the elements of the expense as the "adequate records" provision.

Under Rev. Proc. 2000-9 I.R.B. 280, expenses of traveling away from home may be deemed substantiated. The amount of meal expense deemed substantiated by employees, who are reimbursed by their employers (or another payor) is the lesser of the payor's allowance for meals for the day or the amount computed at the M&IE rate for the locality for such day. Section 4.02. The amount that may be deducted on an employee's or self-employed individual's income tax return (after including any reimbursement received) is the amount computed at the M&IE rate for the locality of travel for the day of travel. Sections 4.03 and 7. There is a special provision for taxpayers working in the transportation industry (including truckers). Section 4.04.

IRC section 274(n) generally requires that the amount of an otherwise allowable deduction for the cost of business entertainment and meals be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

## **Research Materials**

Below list is not designed to be all-inclusive.

- *Commissioner v Heininger*, 320 U.S. 467 (1943).
- *Charron v United States*, 80 AFTR2d 97-6948.
- Revenue Ruling 63-144, 1963-2 CB 129

## **Uniform Issue Numbers**

- 274-01-00 Entertainment, amusement or recreation
- 274-03-00 Traveling
- 274-08-00 Substantiation
- 274-12-00 Business Meals
- 274-13-01 Entertainment
- 274-14-00 Applicable Percentage Limitation

## **PERSONAL SERVICE CORPORATION**

### **Introduction**

Consulting is a qualifying field within the meaning of personal service corporations. Many businesses that describe their services as consulting may not necessarily meet the definition of consulting outlined in the Treasury Regulations. The definition under Treasury Regulation section 1.448-1T(e)(4)(IV) states that

the performance of services in the field of consulting means the provision of advice and counsel. This does not include services such as sales or brokerage services, or economically similar services.

**Significant area of concern:**

Does a C corporation meet the definition of a qualifying personal service corporation? Reasons for concern:

1. Some C corporations may want to be considered a personal service corporation in order to be able to use the cash method of accounting.
2. Some C corporations may not want to be considered a personal service corporation in order to take advantage of the graduated tax rates.

**Pre-Audit**

Examiners need to be aware that, as stated in the overview, consultants can be anything. Many businesses use the word consulting to describe their services when, in fact, they are not only providing advice and counsel, but are also providing other services. This potential issue is driven by the facts and circumstances. As a result, a thorough interview is vital. See Exhibit E. See also Exhibit D for sample Information Document Request.

**Audit Techniques**

Review the stock record book to verify stock ownership.

Review contracts to verify the facts and circumstances which have been obtained in the interview.

If a determination is made that the taxpayer is a personal service corporation other issues to consider may include:

1. Passive Activity Rules (There is an audit techniques guide available.)
2. Taxable Year (generally a calendar year)
3. Employee-Owner compensation deduction limitation (if an election has been made to use a taxable year, other than a calendar year).
4. Personal Service Corporation formed to avoid or evade income tax.

## Law

### Accounting Method

IRC section 448 denies certain entities the use of the cash method of accounting. A "qualified personal service corporation" is an exception to the rule of IRC section 448. To qualify as a qualified personal service corporation, the corporation must meet a "function test" and an "ownership test."

The "function test" requires that 95 percent of the entity's activities involve the performance of services in one of the areas listed in Treas. Reg. section 1.448-1T(e)(4)(i). Consulting is one of the areas listed in this regulation. Treas. Reg. section 1.448-1T(e)(4)(iv) defines "services performed in the field of consulting" as the provision of advice and counsel and excludes performance of sales or brokerage services, or economically similar services. In determining whether the services performed fit within this definition, this section advises that you must look to all the facts and circumstances, which include the manner in which the taxpayer is compensated for the service provided. The regulation provides examples to illustrate the distinction between consulting and sales or brokerage services.

The "ownership test" requires that 95 percent of the entity's stock be owned directly or indirectly by active or retired employees engaged in providing such services, their estates, or any other person acquiring the stock by reason of their death. Indirect ownership may be held through a partnership, S-Corporation, another personal service corporation, or a grantor trust and community property laws are disregarded. No other attribution rules apply. Treas. Reg. section 1.448-1T(e)(5)(iii) and (iv).

### Tax Rates

IRC section 11(b)(2) does not allow personal service corporations the advantage of using the graduated tax rates. There is a set percentage applied to the taxable income. See Code for applicable personal service corporation.

### Passive Losses

The passive activity loss limitations of IRC section 469 apply to personal service corporations to insure that passive losses may not be offset against active income. IRC section 469(a)(2). This section adopts the definition of "personal service corporation" set forth in IRC section 269A, with certain modifications. IRC section 469(j)(2)(A) substitutes "any" ownership of stock for the 10 percent requirement in the definition of "employee-owner." The performance of any services for a corporation renders the person an employee for this purpose, even if that person would be considered an independent contractor for other purposes. Treas. Reg. section 1.441-4T(h)(1). The attribution rules of IRC section 318 generally apply in determining ownership in the personal service corporation,

again modified so that "any" stock interest in a corporation who has "any" interest in the personal service corporation will cause the employee to be considered an "owner" in that corporation.

To determine whether the corporation is a personal service corporation, you must determine whether any "employee-owners" owned more than 10 percent of the stock, by value of the corporation on the last day of the testing period, which is generally the preceding taxable year. You must also determine if the performance of personal services was the principal activity during the testing period. This determination depends on whether more than 50 percent of the corporation's compensation costs during the testing period were attributable to personal service activities. Treas. Reg. section 1.441-4T(f). The final determination is whether the personal services provided by the personal service corporation are "substantially" performed by employee-owners. This determination is made by determining if more than 20 percent of the corporation's compensation costs were attributable to services performed by employee-owners. Treas. Reg. section 1.441-4T(g)(1). If all these criteria are met, the corporation is a personal service corporation and is subject to the passive loss limitations.

### **Taxable Year**

In general, for a personal service corporation, the calendar year is required for the taxable year for all taxable years beginning after 1986. IRC section 441(i). The definition of what constitutes a personal service corporation is the same analysis as discussed above to determine the application of the passive loss limitations under IRC section 469.

### **Employee-Owner Compensation Deduction Limitation**

IRC section 280H limits the deduction allowed for amounts paid by a personal service corporation to employee-owners. This section is only applicable if the corporation has made an election under IRC section 444 to use a taxable year other than the required taxable for a personal service corporation and has failed to meet minimum distribution requirements for the taxable year.

### **Tax Avoidance by Personal Service Corporations**

Under IRC section 269A, the Service has the power to allocate income, deductions, credits, exclusions and other allowances between a personal service corporation and its employee-owners. Three conditions must be satisfied before reallocation may be made under this section. These requirements are: 1) substantially all of the services of a personal service corporation are performed for or on behalf of one other corporation, partnership, or other entity; 2) the principal purpose of using the personal service corporation is the avoidance or evasion of Federal income tax by reducing income or increasing deductions that would not otherwise be available; and 3) the allocation is necessary to prevent the avoidance or evasion of Federal income tax or clearly reflect the income of the personal service corporation or any of its employee-owners.

Under this section, "personal service corporation" means a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners. Generally, "employee-owners" is any employee of the corporation who on any day during the taxable year owns more than 10 percent of the outstanding stock of the corporation. For purposes of determining "employee-owners," the constructive stock ownership rules of IRC section 318 apply, with certain modifications.

Note that safe harbor protection is provided for certain personal service corporations under Proposed Treas. Reg. section 1.269A-1(c). Generally, a personal service corporation will be deemed not to have been formed or availed of for the principal purpose of avoiding or evading Federal income taxes if the reduction in Federal income tax liability of each employee-owner does not exceed certain amounts.

### **Uniform Issue Number**

- Exception to graduated tax rates
- 269A-02-01 Personal Service Corporations
- 269A-02-02 Employee-Owner
- 280H-00-00 Limitations on certain amounts paid to employee-owner by personal service corporations electing alternative taxable year
- 441-07-00 Taxable year personal service corporation
- Election of taxable year other than required year
- Taxpayer qualified to make election
- Cash Limitation
- Qualified personal service corporation exception
- Function test
- Ownership test
- Disallowed loss and credit (passive activities)

# **NOT-FOR-PROFIT**

## **Introduction**

Examiners need to consider the not-for-profit issue when examining business consultants. This is an area which can easily lend itself to abuse. The use of the word "consultant" in a business title provides an air of legitimacy to the business purpose.

An example of a possible abuse in this area, could be the writing off of a second residence and associated expenses in an exclusive resort. The taxpayer states that he is in the business of health consulting providing services to clients at the resort. The taxpayer is deducting expenses while having little or no revenue.

## **Pre-Audit**

When an examiner is reviewing a tax return and there are small gross receipts, large expenses and large losses, the examiner needs to be alert to the potential not-for-profit issue. This is a Schedule C and/or Subchapter S issue. As such, the examiner will want to run transcripts to review the taxpayer's loss history. A thorough interview is critical in developing this issue. See Exhibit E.

## **Audit Techniques**

The examiner needs to review all the facts and circumstances gathered during the initial interview and the review of the returns, in order to determine if the activity is for profit or not-for-profit. No one factor is determinative.

## **Law**

The "hobby loss" rules of IRC section 183 limit the deduction by taxpayers of expenses from activities that are not engaged in for profit. A taxpayer may deduct expenses that fall under IRC section 183 only to the extent of gross income from the activity during the taxable year. Thus, losses attributable to activities not engaged in for profit are disallowed.

"Activity not engaged in for profit" is defined as any activity other than one with respect to which deductions are allowable for the taxable year under IRC section 162 or paragraphs (1) or (2) of IRC section 212.

IRC section 183(d) creates a presumption of profit intent if a taxpayer's gross income from an activity exceeds the deductions from that activity for at least 3

taxable years out of 5 taxable years ending with the relevant taxable year. There is no negative inference from the failure to meet the presumption test. The taxpayer may establish profit motive even though he fails the test required for the presumption. The Service may rebut the presumption of profit.

IRC section 183 applies to deductions attributable to "an activity." The taxpayer must segregate activities and allocate income and expenses between multiple activities to determine the applicability of IRC section 183.

Although the determination of intent of the taxpayer is subjective, objective facts are used to determine this intent. No one factor or counting of factors is conclusive, and all facts and circumstances must be taken into account to determine profit motive. Treas. Reg. section 1.183-2(b) indicates the following factors are relevant in determining profit intent:

1. Manner in which the taxpayer carries on the activity - Carrying on the activity in a businesslike manner and maintaining complete and accurate books and records may indicate a profit intent.
2. Expertise of taxpayer or advisors - Study of business practices within an activity and consultation of advisors may indicate profit intent if the advice or study is followed by the taxpayer.
3. Time and effort expended by taxpayer in activity - Substantial time spent in the activity with little or no personal or recreational aspects may indicate a profit intent.
4. Expectation that assets used may appreciate -Profit includes appreciation and may indicate profit intent.
5. Success of taxpayer in carrying other activities - Ability to convert unprofitable into profitable activities in the past may indicate profit intent even though no current profit.
6. Taxpayer's history of profit or loss with respect to activity.
7. Amount of occasional profit earned - Large occasional profit may indicate profit intent.
8. Financial status of the taxpayer - Lack of substantial income or capital from other sources may indicate profit intent.
9. Elements of personal pleasure or recreation - The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved.

Other miscellaneous factors that may indicate profit intent include the presence of advertising and profit sharing with others engaged in the activity.

## **Research Materials**

Below list is not designed to be all-inclusive.

- T.D. 7198, 1972-2 CB 166
- *Brown v Commissioner*, TC Memo 1983-291
- *Ladner v Commissioner*, TC Memo 1982-207

## **Uniform Issue Numbers**

- Activities not engaged in for profit
- Deductions allowable
- Separate activities
- Presumption that activity is engaged in for profit

## **REIMBURSED EXPENSES**

### **Introduction**

Reimbursed expenses are expenses which the taxpayer will recoup directly from their client. These are very common in the consulting industry. They can include travel, meals, products and advertising, among others. Examiners may find one or more of the following scenarios in the taxpayer's accounting system:

1. The taxpayer will reflect the reimbursed funds as income and then take a corresponding deduction.
2. The taxpayer will net the income and the associated expense through one account.
3. The taxpayer will not record the income but will deduct the related expense.
4. Reimbursements provided under nonaccountable plans are taxable wages subject to employment taxes. Reimbursements provided under accountable plans that are in excess of substantiated expenses are taxable wages subject to employment taxes if excess is not returned within a reasonable period of time. See section 62 of the Internal Revenue Code.

Based on these scenarios, the examiner will want to be alert to the tax effect of reimbursed expenses given the taxpayer's method of accounting.

Since reimbursed expenses are very common in this industry, the examiner needs to determine who is responsible for the 50 percent limitation on business meals

and entertainment. If the taxpayer is not being reimbursed the limitation applies to the taxpayer.

## **Pre-Audit**

Reimbursed expenses may be reflected on the tax return in various ways. Some taxpayers differentiate reimbursed expenses as a separate line item, while others include the deduction on the return under the specific expense.

- The scenario of most concern is the deduction of the expense without the inclusion of the reimbursement as income.
- The other area of importance is, who is responsible for the 50 percent limitation on business meals and entertainment.

During the pre-audit analysis, the examiner should prepare interview questions pertaining to reimbursed expenses. See Exhibit E. Additionally, the examiner may want to chose potential reimbursable expenses and request an appropriate sample on the initial Form 4564, Information Document Request. See Exhibit D.

## **Audit Techniques**

The examiner should chose a sample of invoices or contracts and trace the income and reimbursed expenses to the books. This analysis will verify that the income is reported and that a corresponding expense may be deducted.

Additionally, while sampling invoices or contracts, the examiner can verify that the taxpayer has properly applied the percentage limitation to all unreimbursed meals and entertainment.

## **Law**

IRC section 61 is used for the inclusion of income from whatever source derived. IRC section 162 allows a deduction for all ordinary and necessary expenses incurred while carrying on a trade or business.

Treas. Reg. section 1.274-5T(h) discusses the reporting and substantiation of certain reimbursements of persons other than employees. This includes reimbursement arrangements with a client or customer.

IRC section 274(n) generally requires that the amount of an otherwise allowable deduction for the cost of business entertainment and meals be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

## **Uniform Issue Numbers**

- Gross income versus not gross income
- Reimbursement for expense - non employee
- 162-00-00 Business Expenses
- 274-01-00 Entertainment, amusement or recreation
- 274-03-00 Traveling
- 274-08-00 Substantiation

## GLOSSARY OF TERMS

**Downsizing** — The term used by companies who are permanently eliminating jobs in an effort to decrease costs.

**Hybrid Company** — A consulting firm that not only provides consulting services, but also provides other services or goods. An example is: a computer consulting firm that provides computer consulting services, as well as, the sale and installation of the computer hardware and/or software that they have recommended.

**Job Broker** -- Firms who provide independent consultants to various subcontractors.

**Networking** — A marketing tool used by consultants to generate word-of-mouth referrals. This is done by engaging in activities with other professionals in various industries.

**Reimbursed Expenses** -- Expenses incurred by the taxpayer which are billed to their client.

**Rolodex System** — A collection of companies and/or other individuals with different expertise that a person can refer to in order to obtain various services needed in their company. Normally, there is an informal agreement to make use of each other's services whenever possible.

**Strategic Alliance** -- An affiliation with other companies whose expertise varies from their own. This is done with the intent of providing full service to a client. Each affiliate works as a member of a team to fulfill the requirements of a contract. Such an alliance allows members of the alliance to provide "one stop shopping" for a client and creates a virtual company.

**Value Based Arrangement** -- A payment arrangement used by some consultants where the consultant makes the up-front investment in work and does not charge the client until the promised benefits are realized.

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**DEMOGRAPHICS**

**EMPLOYMENT BY INDUSTRY**

Total	8.456(million)
Percent	100.0
Agriculture	5.7%
Mining	2.0%
Construction	20.7%
Manufacturing	4.7%
Transportation and public utilities	5.1%
Wholesale and retail trade	13.6%
Finance, insurance, & real estate	8.4%
Services	41.4%
Public administration	.2%

**EMPLOYMENT BY OCCUPATION**

Total	8.456(million)
Percent	100.0
Executive, administrative, and managerial	20.7%
Professional speciality	17.9%
Technicians and related support	.8%
Sales occupations	17.9%
Administrative support, including clerical	3.9%
Services	9.1%
Precision production, craft, and Repair	17.9%
Operators, fabricators, and laborers	6.8%
Farming, forestry, and fishing	5.1%

Summarized from Tables 6 & 7 of the 1997 CPS - Employed persons with alternative work arrangement, by occupation and industry respectively.

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**LIST OF ASSOCIATIONS**

American Association of Insurance Management Consultants  
American Association of Political Consultants  
American Association of Professional Bridal Consultants  
American Association of Professional Consultants  
American Consultants League  
American Institute of Consulting Engineers  
American Society of Agricultural Consultants  
American Society of Architectural Hardware Consultants  
American Society of Consulting Planners  
American Society of Irrigation Consultants  
Association of Consulting Actuaries  
Association of Image Consultants International  
Association of Independent Consultants  
Association of Internal Management Consultants  
Association of Noise Consultants  
Association of Outplacement Consulting Firms  
Association of Professional Communication Consultants  
Association of Professional Writing Consultants  
Association of Profile Consultants  
Association of Quality Management Consultants  
Association of Trial Behavior Consultants  
Consultant's Network  
Consultants Institute  
Consultants on Gender and Development  
Creative Business Consultants  
Independent Computer Consultants Association  
Independent Educational Consultants Association  
Institute of Certified Professional Business Consultants  
Institute of Employment Consultants  
Institute of Roofing and Waterproof Consultants  
Institute of Tax Consultants  
Insurance Consultants Society  
International Association of Career Consulting Firms  
International Association of Merger and Acquisition Consultants  
International Association of Registered Financial Consultants  
Investment Management Consultants Association  
National Association for Church Management Consultants  
National Association of Business Consultants  
National Association of Career Development Consultants  
National Association of Legal Search Consultants  
National Association of Management Consultants

## **EXHIBIT B (2 of 2)**

National Association of Medical Legal Nurse Consultants  
National Association of Vision Program Consultants  
National Council Acoustical Consultants  
National Institute of Certified Moving Consultants  
National Society of Environmental Consultants  
Professional and Technical Consultants Association  
Public Relations Consultants Association  
Sales Promotion Consultants Association  
Society of Catering and Hotel Management Consultants  
Society of Medical-Dental Management Consultants  
Society of Mortgage Consultants  
Society of Pension Consultants  
Society of Professional Management Consultants  
Society of Risk Management Consultants

**INTERNAL CONTROL QUESTIONNAIRE**

	<u>Answers</u>			<u>Comments</u>
	<u>Yes</u>	<u>No</u>	<u>N/A</u>	
<b>GENERAL</b>				
1. Are general ledgers kept up to date and balanced monthly?	_____	_____	_____	_____
2. Are internal financial statements prepared and are they reviewed by an owner or officer?	_____	_____	_____	_____
3. Are the bank accounts reconciled monthly and by whom?	_____	_____	_____	_____
4. Are journal entries approved and adequately explained?	_____	_____	_____	_____
5. Are all employees who are involved in record keeping or custody of assets, or in some position of trust, adequately bonded?	_____	_____	_____	_____
6. Are all employees required to take annual vacations?	_____	_____	_____	_____
7. Are personal transactions of management completely segregated from the business?	_____	_____	_____	_____
8. Are all bank accounts in the name of the Taxpayer recorded on books	_____	_____	_____	_____

Add Other Appropriate Steps:

**EXHIBIT C (2 of 3)**

	<u>Answers</u>		<u>N/A</u>	<u>Comments</u>
	<u>Yes</u>	<u>No</u>		
<b>CASH RECEIPTS</b>				
1. Is mail opened by someone other than the bookkeeper?	_____	_____	_____	_____
2. Is listing of mail receipts prepared by someone other than the bookkeeper?	_____	_____	_____	_____
3. Is listing reviewed and reconciled to cash receipts journal by someone other than the bookkeeper?	_____	_____	_____	_____
4. If cash registers or other mechanical devices are used in recording transactions, are cash register tapes saved and reconciled to cash receipts journal?	_____	_____	_____	_____
5. Are cash receipts deposited intact daily and by whom?	_____	_____	_____	_____
6. Is a detailed duplicate deposit slip prepared and receipted by a bank?	_____	_____	_____	_____
7. Are recorded cash discounts and allowances periodically reviewed by an officer or owner?	_____	_____	_____	_____
Add Other Appropriate Steps.				

**EXHIBIT C (3 of 3)**

	<u>Answers</u>			<u>Comments</u>
	<u>Yes</u>	<u>No</u>	<u>N/A</u>	
<b>Cash Disbursements</b>				
1. Are all disbursements made by pre-numbered checks?	_____	_____	_____	_____
2. Who has signature authority?	_____	_____	_____	_____
3. Is check signing in advance prohibited?	_____	_____	_____	_____
4. Are voided checks retained and accounted for?	_____	_____	_____	_____
5. Are petty cash disbursements evidenced by supporting vouchers?	_____	_____	_____	_____
Add other Appropriate Steps				

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**EXHIBIT D**

FORM 4564	Department of the Treasury Internal Revenue Service	Request Number
	INFORMATION DOCUMENT REQUEST	
TO: (Name of Taxpayer and Company, Division or Branch)	Subject	Submitted to:
	SAIN Number	Dates of Previous Requests

Description of Documents Requested

NOT ALL OF THESE ITEMS SHOULD BE REQUESTED IN EVERY CASE. EXAMINERS SHOULD USE THIS AS A GUIDE AND REQUEST ONLY THE ITEMS THAT ARE APPROPRIATE AND RELEVANT FOR THEIR SPECIFIC CASE

Travel

- Appointment Book/Calendar
- Brochures, itineraries for conventions/seminars
- Regular substantiation i.e. tickets, hotel bills, etc.

Reimbursed Expenses

- Request client contracts or invoices. The reason for this is to:
  1. Verify that the taxpayer is reporting the income so that they can take the corresponding deduction or to verify that the taxpayer is properly netting the income from reimbursed expenses vs. the incurred expense.
  2. To verify that the expenses is not subject to the limitation because it has been reimbursed.

Meals/Entertainment

- Appointment Book/Calendar
- Client contracts/invoices (This is to verify that the expense is not subject to the limitation because it has been reimbursed.)

Personal Service Corporation

- Request a sample of each type of contract.
- Stock Record Book

Independent Contractor vs. Employee

- Contracts between the taxpayer and clients.
- Contracts between the taxpayer and individuals who provide services on a regular basis.

	Name and Title of Requester	Date
FROM:	Office Location	

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## **INTERVIEW QUESTIONS**

NOT ALL OF THESE QUESTIONS WILL BE APPROPRIATE IN EVERY CASE. EXAMINERS SHOULD USE THIS INFORMATION AS A GUIDE AND ASK ONLY THOSE QUESTIONS WHICH ARE APPROPRIATE AND RELEVANT FOR THEIR SPECIFIC CASE

### Travel

- Who are your major clients?
- Where is your client base located geographically?
- How often do you or your employees travel?
- Who travels for the company? Are they allowed to bring a companion? If so, who and why?

### Reimbursed Expenses

- How are reimbursed expenses run through your accounting records? (The examiner may want to ask the taxpayer to walk them through a transaction.)

### Meals/Entertainment

- Do you have a policy on meals and entertainment?
- Do your clients reimburse for meals and entertainment?
- Are you aware that the applicable percentage limitation applies (currently 50%) to meals and entertainment even while in travel status?
- How are these reflected in your accounting records?

### Personal Service Corporation

- What are the business activities? (Get specific details on each business activity.)
- What percentage of time and/or gross receipts apply to each business activity?
- What type of finished product does the taxpayer deliver?
- How is the contract price determined? (hourly rate, commission, contingent)
- Is the corporation closely held? If so, by whom?
- What percentage of time do the shareholders/employees work for this corporation?
- What does each stockholder do?
- What percentage of your employees perform consulting services?

### Not for Profit

- How long have you been in business and what is your profit/loss history?
- Why did you get into this business?
- Questions need to be asked concerning the 9 relevant factors at Treasury Reg. 1.183-2(b) (Tax examiner will want to read the regulations in depth)
  - Manner in which the taxpayer carries on the activity. (Is it performed in a business-like manner?)
  - Taxpayer's expertise
  - Time and effort expended by the taxpayer on the activity

## EXHIBIT E (2 of 2)

- Expectation that assets used in the business will appreciate
- Success of taxpayer carrying on other similar or dissimilar activities
- Taxpayer's history of income/losses with respect to the activity in question
- The amount of occasional profits, if any, which are earned
- Financial status of the taxpayer
- Element of personal pleasure or recreation

### Independent Contractor vs. Employee

(Note: The primary area of concern is control)

First potential issue:

- How did you get into this business?
- Who are your major clients?  
(Follow-up questions if it appears the issue may be present i.e.: one major client) -The examiner should tailor their questions to incorporate behavioral control, financial control and the relationship of the parties. See EXHIBIT F regarding the categories of evidence.

Second potential issue:

- Review with taxpayer what makes up the contracting expense, consulting expense, etc.
- How many different individuals and/or corporations provide these services?  
(Follow-up questions if it appears the issue may be present, i.e.: one or few individual providing services to the taxpayer.)
- The examiner will need to ask questions regarding behavioral control, financial control and the relationship of the parties. See EXHIBIT F for the categories of evidence.

## **EMPLOYEE OR INDEPENDENT CONTRACTOR**

### **Behavioral Control**

#### **A. Instructions**

1. Type of Instructions:
    - a. When to do the work
    - b. Where to do the work
    - c. What tools or equipment to use
    - d. What workers to hire to assist with the work
    - e. Where to purchase supplies or services
    - f. What work must be performed by a specific individual (including ability to hire assistants)
    - g. What routines or patterns must be used
    - h. What order or sequence to follow
  2. Prior Approval
    - a. Requirement to secure prior approval before taking certain actions
  3. Degree of Instruction
    - a. Extent of the detail of the instructions given to the worker
    - b. Effect on the worker in the event of noncompliance
  4. Presence of Instructions or Rules Mandated by Governmental Agencies or Industry Governing Bodies
    - a. Did the business impose the instructions or rules only in compliance with governmental or governing body regulations
    - b. Did the business adopt more stringent rules or regulations than those imposed by governmental agencies or governing bodies
  5. Instructions by Customer
    - a. Did the business pass on instructions given by the customer
  6. Suggestions vs. Instructions
    - a. Is compliance with suggestions mandatory
  - \*7. Business Identification
    - a. Reason for requiring the worker to wear a uniform or placing business name on vehicle, i.e. reassurance to customer, security purposes
    - b. Who incurs the expense
  - \*8. Worker's Occupation
  - \*9. Nature of the Work
    - a. Degree of direction and control required by virtue of the work itself
- \*These aspects may be neutral in the determination of the worker's status

## EXHIBIT F (2 of 3)

### B. Evaluation Systems

1. Measurement of Compliance with Performance Standards
  - a. Influence on worker's behavior in performing the details of the job

### C. Training

1. Type of Training
  - a. What procedures to follow in performing the task
  - b. What method to use
  - c. Updates on company policies, governmental rules or regulations, statutes, orientation, general information sessions
  - d. Is attendance mandatory
  - e. Is the worker compensated for attending the training

## Financial Control

### A. Significant Investment

1. Nature of Business
  - a. Type of business
  - b. What assets are normally acquired for the business
  - c. How the assets are normally acquired, i.e. purchased, leased
  - d. Other expenditures normally encountered in the business
  - f. How are the cost determined, i.e. FMV or FRV, arm's length transaction

### B. Reimbursed v unreimbursed expenses

1. Who bears the costs of the assets and expenditures mentioned above
2. Which expenses are not reimbursed

### \*C. Availability of Services

1. Whether the worker advertises his/her services
2. Location of the business
3. Whether the worker is available to work for the relevant market

### D. Method of Payment

1. Salary or hourly
2. Flat fee
3. Commission

### E. Realization of Profit or Loss

1. Freedom of choice to make decisions which have an impact on the worker's ability to realize a profit or loss

\*These aspects may be neutral in the determination of the worker's status.

**Relationship of the Parties**

A. Intent of the Parties

1. Contractual Relationship
  - a. Consider substance over form
2. Information Returns
  - a. Form W-2
  - b. Form 1099
3. Incorporation
4. Benefits
  - a. Paid vacation days
  - b. Paid sick days
  - c. Health insurance
  - d. Life and/or disability insurance
  - e. Tax-qualifies retirement plan; Sec 403(b) annuity; other pension plan
  - f. Cafeteria plan
  - g. Status determined by state or federal agencies for purpose of providing benefits
5. Discharge/Termination
  - a. Limitation on ability of the business to terminate worker
  - b. Limitation on ability of the worker to terminate working relations ship
  - c. Worker's liability as result of non-performance
  - d. Business's rights in non-performance by worker
6. Regular Business Activity v Services Performed by Worker

B. Term of the Relationship

1. Definite v Indefinite Period
  - a. Long-term
  - b. Temporary
  - c. Written contract

**Facts of Lesser Importance**

- A. Full-Time v Part-Time
- B. Place of Work
- C. Number of Work Sites
- D. Hours of Work

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## **Internal Revenue Code Section 530**

### **A. Reporting Consistency**

Did the business timely file all required tax returns with respect to the worker (including information returns, Forms 1099) for the period under examination on a basis consistent with the business's treatment of the worker as not being an employee?

### **B. Substantive Consistency**

Worker, or Class or Workers, currently treated as independent contractors.

1. Duties:
  - a. Current
  - b. Previous
2. Responsibilities
  - a. Current
  - b. Previous
3. Supervisor or Manager & Title
  - a. Current
  - b. Previous
4. Degree of supervision & control required
  - a. Current
  - b. Previous

### **C. Reasonable Basis**

1. Safe Havens:
  - a. Prior Examination
    - i. Type of examination
    - ii. When was the examination conducted
    - iii. Were same class or workers currently under consideration, treated as independent contractors during the period covered by the prior examination
    - iv. Did taxpayer reasonable rely on the prior examination
  - b. Judicial Precedence or Published Ruling
    - i. When did the business begin
    - ii. When did the business first begin treating its workers as independent contractors
    - iii. Facts in the case similar to the business's situation

## EXHIBIT G (2 of 2)

- iv. Date of the ruling
  - v. Did taxpayer reasonably rely on the ruling
- c. Technical Advice Memorandum, Private Letter Ruling, or other Determination Letter
- i. To whom/what entity was the ruling issued
  - ii. Were the facts materially misstated or omitted
  - iii. Any substantial change in the facts since the ruling was issued
  - iv. Did taxpayer reasonably rely on the ruling
- d. Long Standing Recognized Practice of a Significant Segment of the industry
- i. When did the business begin
  - ii. When did the business first begin treating its workers as independent contractors
  - iii. How were the workers treated previously
  - iv. Define the industry
  - v. How long has the industry existed
  - vi. When did the industry begin this practice
  - vii. Define the geographic/metropolitan area of the industry
  - viii. How prevalent is the practice in the industry
    - 1) Number of firm engaged in this practice
    - 2) Number of workers involved
    - 3) Homogeneity of the industry
  - ix. When did the industry's practice change, if applicable
  - x. Did taxpayer reasonably rely on the industry practice
2. Other Reasonable Basis:  
(More than mere "good faith" is required for section 530 relief. "Good faith" may be basis for not asserting penalties.)

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