



Market Segment Specialization Program



Child Care Providers

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 in *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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CHILD CARE PROVIDERS

Market Segment Definition and Overview

Purpose This MSSP Audit Techniques Guide (ATG) will provide information to enable examiners to effectively audit issues pertaining to child care providers. The ATG will:

- Provide background information
 - Identify frequent and/or unique issues
 - Provide examination techniques
 - Supply applicable law
-

Definition This section defines the four basic categories of child care providers.

Babysitters: These providers generally care for children from one family and are not under regulatory control. In some instances the provider will be a spouse caring for his/her own children and also taking care of one or two additional children for the extra income. Others can be grandparents or other relatives, friends, or neighbors who are either unemployed and welcome the extra money or are not paid, but are willing to look after the children. In these cases, Form 2441 information is possibly incomplete or incorrect. These providers often believe that this income is not taxable and therefore, need not be reported. However, this could result in both income and self-employment tax issues.

Family Day Care: Family Day Care is child care provided in the home of the provider, is non-medical, and is for less than 24 hours. In some states a provider must attend an orientation and/or complete an application-processing seminar to obtain a license. Regulatory requirements may differ from state to state. The provider might be approved, certified, registered, or licensed under applicable state or local laws (IRC section 280A(c)(4)). Contact your applicable state or local agency for this information. California, for example, allows a provider with no assistant to care for no more than four infants or six children. If six children are cared for, no more than three may be infants. This includes the provider's own children under age 12. With an assistant they may care for twelve children, no more than four may be infants, including their own children under age 12.

Market Segment Definition and Overview, Continued

Definition **Child Care Centers:** Many child care centers are organized as corporations filing Forms 1120 or 1120S or partnerships filing Form 1065. These are usually separate facilities, apart from the owner's residence. There may be more than one facility within a corporation or partnership. There may be one or more shareholders or partners involved in several facilities, each of which is organized as a separate corporation. These centers are heavily regulated in most states. These centers are required to report attendance records and other similar information. They also have large commercial kitchen operations, playground equipment, swimming pools, and large quantities of toys.

Home Care: Some children are cared for in their own home by a paid housekeeper, maid, governess, au pair, or nanny. The home caregiver is generally paid as a household employee. The parents show the wages on Schedule H attached to their Form 1040. This situation is not a child care provider business. The nanny, housekeeper, etc. receive wages but do not incur expenses as a child care provider. For a more detailed discussion of child care performed at the child's home, see Publication 503, *Child and Dependent Care Expenses*.

Other: There may be other types of child care providers such as after-school programs, church programs, or other tax-exempt entities. These are not specifically addressed in this document.

Status This guide will focus on the income and expenses of the child care provider. Examination of these returns may result in the following determinations:

- Income and expenses are often paid in cash
- Record keeping is often inadequate
- A net loss is unusual except at the corporate level

Issues most often adjusted include:

- Gross receipts
- Food reimbursement
- Food expense
- Business use of home
- Unusually large expenses
- Supplies and miscellaneous expenses (may include personal)

Market Segment Definition and Overview, Continued

Resources District Market Segment Specialization Program Coordinator
National Market Segment Specialization Program Coordinator
Pub. 583, *Taxpayers Starting a Business*
Pub. 946, *How to Depreciate Property*
Pub. 587, *Business Use of Your Home (Including Use by Day-Care Providers)*

Issues

Income

The following section will address income received by babysitters, family day care operators, and child care centers.

NOTE: The IRS Restructuring and Reform Act of 1998, Section 3412, prohibits the use of financial status examination techniques to determine the existence of unreported income **unless** the IRS has a reasonable indication that there is a likelihood of unreported income.

Babysitters: The income received from this activity is taxable and may be reported either on Schedule C (or CZ) or on the “Other Income” line on the Form 1040. In either case the net income is subject to self-employment tax, if applicable. There are generally no records kept by the babysitter. Sometime the income is discovered from the examination of the customers. When this occurs, the gross receipts can be determined using this information.

It may be necessary to prepare a Cash-T using the return and other available information. Determine if the income reported is sufficient to cover deductions and personal living expenses. If the income reported does not appear to be sufficient, further development may be necessary.

Family Day Care: These entities are usually operated as a business. They generally report their income and expenses on a Schedule C. Verify income by requesting from the taxpayer a rate schedule, ledger cards, attendance lists, contracts/agreements, food reimbursement statements, meal count records, and any records pertaining to regulatory programs.

In the absence of adequate records, select the appropriate indirect method. A bank deposit analysis may not be effective because cash transactions are very common. In many cases the income received may be insufficient to create additional income tax. However, self-employment tax must still be considered.

Money may be received from government subsidies, food program reimbursements, and non-profit organizations. Form 1099 information may be obtained to verify amounts received from these programs.

Issues, Continued

Income Income may be verified using a reconstruction formula. Formulas may vary based on information available in a given case. The following is an example of one reconstruction formula.

Example: Reconstruction of gross receipts using a food reimbursement formula for 1996/1997.

Facts:

The taxpayer received a food reimbursement from a local government agency of \$5,235 for the year.

The taxpayer provided lunch and two snacks per day, per child.

The reimbursement meal rates are \$1.58 for lunch and \$.47 per snack, totaling \$2.52 per day (see sample rates below).*

The average fee per child per five day week is \$100,

The computation, using the facts above is as follows:

Step 1: Divide the annual reimbursement amount (\$5,235) by the daily reimbursement rate (\$2.52) to arrive at the number of “child days” (2,077)

Step 2: Divide the number of “child days” (2,077) by the days of the operating week (5) to arrive at “child weeks” (415)

Step 3: Multiply the “child weeks” (415) by the weekly fee (\$100) to arrive at the tentative gross receipts (\$41,500)

* Be sure to ask the taxpayer how many meals and snacks they provide per child and, of these, how many are subject to a reimbursement program. Also, request a copy of the reimbursement application (or other submission) which should show the number of child days that were used to determine the amount of the subsidy.

Use this formula as a guide to determine if gross receipts appear reasonable. Ask the taxpayer to explain any significant discrepancy. If the taxpayer’s own children are enrolled in the food program, reduce the gross receipts by the appropriate amount. This formula may be used for any number of children. If some of the children do not qualify for a reimbursement program, add the annualized fee for these children to the reconstructed gross receipts.

Issues, Continued

Income

Sample Reimbursement Rates for:

	1996/97	1997/98	1998/99*
Breakfast (meal)	\$0.86	\$0.88	\$0.90
Lunch (meal)	1.58	1.62	1.65
Dinner (meal)	1.58	1.62	1.65
Supplement (snack)	0.47	0.48	0.49

* Reimbursement rates are for July through June from the *U.S. Department of Agriculture, Child and Adult Care Food Program (CACFP)*. Reimbursement rates should be obtained from the applicable state agency which will also provide the guidelines for making a Tier I or Tier II reimbursement determination.

Examiners should be aware that in July 1997 the CACFP was modified to provide a two-tiered reimbursement rate. Those child care providers who fell into Tier II received a significantly reduced subsidy per meal during the second half of the year.

Child Care Centers: These larger entities generally maintain better records. These organizations usually maintain an index card for each child containing, among other things, the dates and amounts of payments of weekly fees and other charges. There may be multiple cards for each child or the provider may maintain a computerized system. When a parent pays the center, the center records the payment on the child's card or database and adds it to a deposit slip. The total deposit, when completed, goes to the bank. Due to the volume of receipts in this type of organization, a bank deposit analysis may be helpful. The center may also have a monthly record of the number of children on the premises and the amount of money actually received for the month for governmental reporting purposes. The accounting method of the taxpayer should be considered as you could also have accounts receivables and bad debts. You can test gross receipts by starting with a sample of the attendance records traced on the return.

Centers generally publish a rate schedule. Request a copy of the schedule for the tax year under examination. Multiply the average number of children in each age/class group by the rates for each group; add any subsidy payments, to arrive at tentative gross receipts.

Issues, Continued

Income Additional gross receipts may come from subsidy programs, sometimes reported on Forms 1099. Another source of gross receipts may be one-time additional fees for registration, outings, or projects.

Centers usually charge late pick-up fees to parents, often ranging from five to ten dollars for each five minutes period beyond closing. These fees, usually paid in cash, may be paid to the center and recorded in the books, or may be paid directly to the staff member who remained overtime for that child. Only amounts paid to the center should be included in gross receipts.

Ask for any contracts between the center and customers' employer. This will apply when an employer subsidizes child care for its employees.

Note: Federal food program reimbursements (ordinarily arranged through state and local agencies) are normally not taxable income if the food expenses are offset against this income. The total cost of the food (less a computed amount for family members) is deductible, so the taxpayer may end up not reporting the reimbursement as an income item and, instead, net it against food expense. If it is not netted, it must be included in full as an income item.

Other Income Other income may come from interest bearing accounts, dividends from investments, or from the sale of assets.

Expenses The following section will discuss expenses commonly found on the returns of child care providers.

Start-up Costs Start-up costs are expenses the taxpayer incurs prior to opening the business. These include advertising costs, inspection fees, supply expenses, pre-opening payroll expenses, professional fees, and other miscellaneous expenses paid or incurred prior to opening day. Depreciation on assets purchased prior to opening day begins on opening day or the day actually placed in service after opening day. Start-up expenditures cannot be deducted as a current expense. These capitalized expenses may be amortized over a 60-month period if the taxpayer elects to claim the amortization. The election must be made on a timely filed return for the tax year in which the business begins. (IRC section 195)

Issues, Continued

Advertising Advertising is usually a minimal deduction for the babysitting and family child care operations. Usually the program sponsors or agencies provide free referral services. Ask for the advertising agreements (not just canceled checks) to verify the expense.

Child care centers usually advertise in telephone directories, local newspapers, church bulletins, flyers, etc. Expenses may be traced to source documents.

Car & Truck Expense Ask about the purpose of this expense. For family child care operations this expense could relate to taking the children to and from school, field trips, medical facilities, etc. Trips for the benefit or entertainment of a particular child at the request of a parent would not generally be the responsibility of the child care provider. If this situation occurs, refer to any individual contractual arrangement. Obtain any necessary log books. For personal vehicles used in the business, verify business percentage with the insurance policy.

Deductions for mileage should be allocated between business and personal expenses. If, however, a taxpayer travels to a single destination and engages in both personal and business activities, the expense is deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the expense is not deductible even though the taxpayer engages in business while at such destination. Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If a trip involves multiple locations, then only the mileage to/from the business-only destination is deductible.

If a trip is primarily for business, the taxpayer may deduct actual expenses or use the standard mileage rate, depending on the facts and circumstances. Vehicle expenses, including the vehicle cost or other basis, and the number of personal and business miles driven during the year must be substantiated.

Issues, Continued

Car & Truck Expenses Child care centers generally maintain vans for transporting the children. The expenses associated with these vans would be an ordinary and necessary expense. These vans are usually 100 % business.

Commissions and Fees Fees shown here are generally for the staff of the facility. This normally would not be an issue for a family child care facility. Larger facilities may contract with landscaping businesses, repair businesses, and even substitute teachers/staff. Filing of Forms 1099 may be an issue. When examining these payments, carefully consider whether this is an employment tax issue. See further discussion of worker's compensation under wages.

Depreciation Depreciation (IRC sections 167, 168, and 179) may be available for computers, vehicles, office equipment, kitchen equipment, playground equipment, etc. Assets that are converted from personal to business use should use fair market value at the time of conversion as basis for depreciation.

Some items that are commonly depreciated include:

Camcorder -- Under normal circumstances this is not an ordinary and necessary business deduction.

VCR -- Apply business percentage.

Television -- Determine the number and location of televisions and apply business percentage.

Stereo, piano, guitar, etc. -- Determine the business use. Consider that these items may have been purchased for a member of the household.

Computer -- Apply business use percentage to hardware, software and games.

Furniture, Appliances, and Yard Equipment -- Use business percentage.

**Employee Benefit Prog/
Pension &
Profit Sharing** Employee benefit programs may consist of insurance benefits and various retirement plans. This can be a complicated issue. Follow local procedures to determine if a referral is necessary. See appropriate publications for further information on benefit plans.

Issues, Continued

Insurance This expense normally includes general business liability coverage, workmen's compensation coverage for employees, asset insurance for large assets used by the facility, and other property related insurance costs. This does not include home owner's insurance. For insurance related to "Business Use of Home," see discussion later in this guide.

Rent Rental expenses should be allocated according to business use percentage. If the rental is for the personal residence, see "Business Use of Home" below.

Telephone Expense The monthly expense for basic local telephone service is a nondeductible personal expense (IRC section 262(b)), even though the state requires the provider to have a telephone in order to be licensed. Additional telephone charges incurred for business purposes are deductible under IRC section 162 to the extent substantiated.

Supplies This expense may include food (previously discussed), toys, diapers (often provided by the parents), office supplies, cleaning supplies, educational and art supplies, etc. Some of these items are discussed later under "Other Expenses."

Travel, Meals, Entertainment Travel away from home overnight may consist of attending seminars. Refer to IRC section 274(c), (d), (e), and (h) for deductibility of travel.

The meal expense in this area relates to management's business meals limited by IRC section 274. This does not include meals for the children. The entertainment expense does not include entertainment of the children. Examine any other entertainment expense within the requirement and limitations of IRC section 274.

Utilities The cost of utilities is generally an allowable expense. For family child care, see discussion of "Business Use of Home."

Issues, Continued

Bad Debts A “cash method” taxpayer should not have a bad debt expense. An “accrual method” taxpayer may have bad debts generated by non-payment for services provided.

**Wages/
Compensation** **Family Child Care:** These entities usually do not have paid workers. Payments made to the sole proprietor taxpayer are considered “draws” and are not deductible under wages or any other category. Payments made to the sole proprietor’s family members may be deductible if bona fide services are performed. See Publication 15, Circular E, for related employment tax details.

Child Care Centers: These entities often have workers who are directors, assistant directors, teachers, assistants, cooks, drivers, etc. These workers are generally considered employees. Wages for these people are deductible and normal employment taxes apply.

Workers who may not be treated as employees are independent contractors for such things as yard maintenance, lifeguards, etc. Payments made to these workers are deductible and may be included in this expense, commissions, cost of goods, or other expenses. The child care center is responsible for meeting the requirements of IRC section 6041 for information return reporting.

**Other
Expenses** **Food:** Some taxpayers use the “Cost of Goods Sold” line, the “Supplies” line, or a line with “Other Deductions” to report food expense. If the taxpayer has not reported the food reimbursement as income, then the taxpayer must show an adjustment decreasing the total for food expense. Any expenses associated with a sole proprietor’s family should be removed from total food expense as non-deductible personal expense (IRC section 262). Food purchased in excess of the amount received from food reimbursement programs is deductible if verified as a business expense.

Food may be bought in large quantities in larger child care operations. Freight charges may be included in the food account. Some centers provide meals for the children’s family members on special occasions, such as Christmas, without charge. These expenses are usually included in food expense.

Issues, Continued

Toys: This can be a significant expense depending on the size of the operation. Some toys may be depreciable while others may be deductible. Refer to IRC sections 167, 168, and 179 and Publication 946, *How to Depreciate Property*, for information on this distinction. Examine this item for large, unusual, questionable, and personal items.

Bank Charges: Bank charges are allowable for a separate business account. For a combined business/personal account, bank charges are allowed to the extent of the business percentage.

Gifts: Gifts to the children or their parents are limited to \$25 per client per year and must meet the record keeping requirements of IRC section 274(d).

Miscellaneous: The “Other” expense category may be used to deduct expenses separately identified on the return.

Business Use of Home

Expenses associated with business use of home, for care in the home of the provider, must be calculated using Form 8829, *Expenses for Business Use of Your Home*.

The qualifications for office in the home expenses are different for child care providers than for other businesses. Unlike most businesses, qualifying usage does not require exclusive use. Regular usage is generally qualifying. For specific requirements see IRC section 280A(c)(4). IRC section 280A(c)(5) limits the deduction if the taxpayer’s expenses exceed gross income from the child care activity.

Determining Business Percentage: The Instructions for Form 8829, *Expenses for Business Use of Your Home*, clearly explain the special computation for certain day care facilities. Follow the computation in Part 1 of Form 8829 explicitly. Lines 4 to 6 include the day care provisions. Verify the square footage of the house and the business use portion.

Issues, Continued

This can be done in several ways, such as reviewing house plans, blueprints, escrow papers, or any other documents that substantiate the square footage.

The total number of hours the facility was used for day care during the year is also part of the computation for determining business percentage. The taxpayer is instructed to multiple the days used for day care during the year by the hours used per day. Hours spent cooking, cleaning, and preparing activities for the business of child care could be included in the calculation of the time-space percentage if the tests for deduction under section 162 of the Code are otherwise met under the facts of the particular case. For example, if a child care provider spends one-half hour setting up for the children and one-half hour returning a room to personal use, in addition to seven hours actually in the presence of the children, he/she could claim that eight hours were expended in the business. As with any business use of a home, care providers must substantiate claims for hours expended in the conduct of the business of providing child care.

Figuring the Allowable Deduction: Continuing on Form 8829 you will need to determine which expenses are direct and which are indirect. Direct expenses are those that are exclusively for the business, with no personal benefit derived. Indirect expenses are those that are not exclusively for the business, i.e., expenses which benefit both the business and the home. Indirect expenses must be allocated using the business use percentage. The portion of mortgage interest and property taxes not deductible on Form 8829 should then be reported on Schedule A. Verify any necessary entries.

IRC section 265(a)(1) will operate to disallow a portion of certain otherwise deductible expenses for business use of the home if the child care provider and the provider's spouse file joint returns and receive a tax-exempt housing allowance. The deductions that would be subject to partial disallowance would include trade or business expenses under IRC section 162, trade or business casualty losses deductible under IRC section 165(c)(1), most state and local and other taxes deductible under IRC section 164(a), and depreciation deductible under IRC section 167. The business portion of any interest deductible under IRC section 163, or of state, local, and foreign real property taxes deductible under IRC section 164(a)(1) will not be affected by IRC section 265(a)(1). Under IRC section 265(a)(6) the recipient of a tax-exempt military housing

Issues, Continued

allowance (or a parsonage allowance exempt under IRC section 107) is allowed to fully deduct otherwise deductible home mortgage interest and real property taxes.

The courts have stated that the legislative purpose behind IRC section 265 is to prevent taxpayers from reaping a double tax benefit by using deductions attributable to tax-exempt income to offset taxable income (*Induni v. Commissioner*, 98 T.C. 618, 621 (1992) *aff'd*, 990 F.2d 53 (2d Cir. 1993)).

In determining the amount of business expense properly deductible in the event (1) a tax-exempt military housing allowance is received and (2) the home is used for the business of providing child care, the methodology described in Rev. Rul. 92-3 should first be applied to each type of deductible expense. The amount of mortgage interest and real property taxes so determined should be claimed on the Form 8829, with the balance claimed on Schedule A, Form 1040 (assuming itemized deductions are used). All remaining potential deductions should then be multiplied by a fraction, the numerator of which is the tax-exempt military housing allowance and the denominator of which is total cost of running the household. The resultant amount is the amount to be disallowed.

The effects of this formula may be shown as follows.

The taxpayers receive a \$6,000 housing allowance and their housing expenses total \$7,000, of which \$4,000 is property taxes and mortgage interest and \$3,000 are other expenses of maintaining the home (including \$500 for house depreciation allocable to the business use of the home for the child care activity). There is a 30% time and space use allocation of the home to the child care activity. The deductibility of the property taxes and mortgage interest is unaffected by IRC section 265. Accordingly, the normal allocation required by IRC section 280A should be performed. So, 30% of the \$4,000 property taxes and mortgage interest, or \$1,200, should be reported on Form 8829 as allocable to the child care business. The remainder, \$2,800, should be reported on Schedule A in the appropriate categories.

Issues, Continued

An allocation of the remaining \$3,000 of expenses is required by IRC section 265. First, determine the amount attributable to the child care activity by multiplying 30 percent by those house expenses other than depreciation (\$2,500), which equals \$750. Then calculate the amount of house depreciation that would normally be allowed if fully claimed on Form 8829 (\$500) and add this to the business portion of the remaining expenses (\$750) equaling \$1,250. Next, \$6,000 of the total \$7,000 housing expenses was allocable to the housing allowance. Thus $\frac{6}{7}$ th of the \$1,250 or \$1,071.43 cannot be allowed as a deduction by virtue of IRC section 265. This leaves only \$178.57 of the additional housing expenses that are deductible on Form 8829.

Depreciation of the Home: This only applies to the residence building and not the value of the land, equipment or other depreciable assets. To determine the depreciable basis, use the lesser of (1) cost or other basis of the home, or (2) the fair market value on the date the property is placed in service for business. Other depreciable assets of both a direct and indirect nature should be included under depreciation discussed earlier.

Modifications to the Home: Expenses incurred in modifying a residence to comply with licensing requirements should be treated as a capital improvement. A capital expenditure includes any amount paid for permanent improvements or modifications that extend beyond the tax year made to increase the value of the property. These types of improvements are generally depreciable.

Sale of Home: A capital gain issue may arise if the taxpayer sells the residence in which he/she operated a business and claimed depreciation deductions as part of the Business Use of Home expenses. This will result in an adjustment to the basis of the home and may result in a reportable IRC section 1231 gain. Refer to IRC sections 1016(a)(7) and 121(d)(6).

Examination Techniques

Business Use Of Home Sale of Home: The relevant Code section addressing the relationship of prior and current year depreciation and inclusion of gain on sale is now IRC section 121. If the residence was used partially for residential purposes and partially for business purposes, only that part of the gain allocable to the residential portion is excludable under IRC section 121.

If property is used exclusively as the taxpayer's principal residence in the year of sale, the taxpayer is not necessarily entitled to the exclusion under IRC section 121. The taxpayer must look back five years from the date of the sale and determine whether the property was owned and used as the taxpayer's principal residence for at least two years during the five-year period. Only gain attributable to the portion of the property meeting the two-year ownership and use requirements can be excluded.

IRC Section 121(d)(6) provides that the exclusion provided under IRC section 121 does not apply to any gain from the sale of a principal residence attributable to depreciation adjustments (as defined in IRC section 1250(b)(3)) taken after May 6, 1997. Therefore, a taxpayer who used part of his/her home for business purposes may not exclude any gain from the sale of that residence that is attributable to depreciation adjustments taken after May 6, 1997.

Examination Techniques (Continued)

Sample IDR Shown below are items examiners may want to consider when preparing an Information Document Request (IDR) for a child care provider.

NOTE: While the list is not all inclusive, at the same time, not all items should be requested in every case. Examiners should use this information as a guide and request only the items that are appropriate and relevant for their specific case.

1. Be prepared to discuss the business history including the starting date, a brief description of a typical day's activities, and internal controls for income and expense information.
 2. If you are taking a deduction for the use of your home, provide a floor plan, blueprint or other significant documents to reflect the square footage of the residence. Provide the escrow and/or closing statement to verify the cost of the property. Mortgage company statements showing the paid property tax and interest amounts should be provided to verify these deductions. If you are renting your home, provide substantiation of the expense and a copy of the rental agreement.
 3. Provide copies of Federal Tax Returns for prior and subsequent years; prior Federal and State audit reports; any related returns: partnership, corporation, or employment tax returns, and any Forms 1099 filed and/or received.
 4. Provide journals, ledgers, records, notebooks used to keep a record of clients and the amount they paid (weekly, monthly, etc.).
 5. Provide all bank statements, business and personal, for the period beginning _____ and ending _____.
 6. If you are a participant in a food program, provide copies of the reimbursement statement, name and address of the food sponsor, attendance and meal count record, and time record.
 7. Provide a copy of any benefit or retirement plan.
 8. Provide substantiation in the form of canceled checks, receipts, statements, or invoices for expenses identified for examination.
 9. Provide all business licenses, approvals, registrations, and certifications.
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Examination Techniques (Continued)

Child Care Credit There are situations when the child care credit claimed by a taxpayer has a direct effect on an examination of a child care provider. The audit of the child care credit taxpayer may be used as a means of identifying providers. This is of particular concern when the identified provider is not reporting the payments received. Additionally, a child care provider may be claiming the child credit for his or her dependent child being cared for by the taxpayer's business.

Employee vs Independent Contractor The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification -- independent contractor or employee -- can be valid. For an in-depth discussion, see the training material "Independent Contractor or Employee?", Training 3320-102 (Rev. 10/96) TPDS 8428I, for determining employment status. The training materials are also available on the IRS home page on the Internet at www.irs.gov.

The first step in any case involving worker classification is to consider section 530 of the Revenue Act of 1978. Before or at the beginning of an audit inquiry relating to employment status, an examiner must provide the taxpayer with a written notice of the provisions of section 530. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's but not the worker's employment tax liability, including any interest or penalties attributable to the liability for employment taxes.

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency -- whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent -- and depends on the principal's right to direct and control the agent.

Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: sections 31.3121(d) -1, 31.3306(i) -1, and 34.3401(c) -1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the

Examination Techniques (Continued)

work, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed; if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

The Service now looks at facts in the following categories when determining worker classification: behavioral control, financial control and relationship of the parties.

Behavioral Control: Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.

Financial Control: Facts on whether the business has the right to direct or control the economic aspects of the worker's activities should be analyzed to determine worker status. Economic aspects of a relationship between the parties illustrate who has financial control of the activities undertaken. The items that usually need to be explored are whether the worker has a significant investment, unreimbursed expenses, whether the worker's services are available to the relevant market, the method of

Examination Techniques (Continued)

payment and opportunity for profit or loss. The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs services.

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. Significant investment, unreimbursed expenses, making services available, and method of payment are all relevant in this regard. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize profit or loss.

Relationship of the Parties: The relationship of the parties is important because it reflects the parties intent concerning control. Courts often look to the intent of the parties; this is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the party's intent that a worker is an independent contractor -- especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. The designation or description of the parties is immaterial. This means that the substance of the relationship governs the worker's status, not the label.
