

“A monthly report on employment tax and other issues of importance to the business and government entities that use independent contractors.”

# *The Independent Contractor Report*

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## **IN THIS ISSUE**

- ◆ Bakery Treated Production Workers and Route Distributors as Independent Contractors 1
- ◆ Court Held IRS Should Have Granted Section 530 Safe-Haven Relief 5
- ◆ Table of Recently Reported Cases and Rulings Involving the Independent Contractor Issue 8

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## **BAKERY TREATED PRODUCTION WORKERS AND ROUTE DISTRIBUTORS AS INDEPENDENT CONTRACTORS**

◆  
In 1991, firm treated virtually everyone as employees. In 1992, they switched to independent contractor treatment.

◆  
IRS examined the firm and determined the workers were still employees.

◆  
The matter was before the United States Tax Court on a “petition for redetermination of a Notice of Determination Concerning Worker Classification Under Section 7436 (Notice of Determination).” The issues for decision were:

- (1) Whether the workers performing services for petitioner were employees during 1992;
- (2) Whether petitioner is entitled to safe harbor relief as provided by section 530 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2885 (section 530); and
- (3) Whether the Court's jurisdiction to decide the proper amount of employment taxes provides the Court

with jurisdiction to decide the proper amount of additions to tax and penalties related to employment tax arising from worker classification or section 530 treatment determinations.

**The firm manufactured** bakery products “such as cookies, brownies, and cinnamon buns.”

“Petitioner was a Virginia corporation that had its principal place of business in Lorton, Virginia. At the time it filed its petition, petitioner had terminated its corporate status. Prior to and during 1992, petitioner manufactured bakery products such as cookies, brownies, and cinnamon buns. Peter Ewens (Ewens) was the president, and Roger Miller (Miller) was the vice president of petitioner. Ewens ran petitioner on a day-to-day basis and controlled petitioner's operations. Miller was a financial adviser to petitioner. During its operation, Miller was at petitioner's plant approximately once a month. Miller was a C.P.A. who had his own company that prepared tax returns. Miller prepared petitioner's Federal corporate income tax returns for 1991 and 1992. He also signed petitioner's Federal employment tax returns for 1992.”

**The firm treated its “bakery workers”** as employees and then, in 1992, began to treat them as independent contractors.

“Petitioner had several categories of workers including bakery personnel and production workers (bakery workers), cash payroll workers, route distributors/sales people (route distributors), and outside sales workers. The bakery workers worked at petitioner's plant. Using equipment and supplies provided by petitioner, they mixed dough, and baked and packaged petitioner's products. Although petitioner did not set the bakery workers' hours, each day a certain amount of production had to be completed, and the bakery workers could not leave until the production quota was met. Petitioner paid the bakery workers a fixed amount based on the amount of product they produced. Prior to 1992, petitioner treated the bakery workers as employees. In 1991, petitioner issued the bakery workers Forms W-2, Wage and Tax Statement. In 1992, 30 out of petitioner's 37 bakery workers received Forms 1099. Of the seven who did not receive a Form 1099, only two earned less than \$600.”

**In 1992, the firm did not issue** Form 1099s to any of its twenty-one route distributors.

“The cash payroll workers were a family of six or seven individuals known as ‘the Rusli group’. The Rusli group was not a corporation. The Rusli group worked for petitioner for a number of years prior to 1992. The Rusli group performed the same work as the bakery workers. Since 1987, pursuant to a written agreement between the Rusli group and petitioner, the Rusli group also supervised the bakery workers. In 1992, petitioner did not issue Forms 1099 to any of the cash payroll workers. The route distributors transported petitioner's product from its plant to individuals or businesses who purchased the product. Some route distributors bought the product and resold it for a higher price; others worked on a commission basis. The route distributors drove their own vehicles. Petitioner did not set the hours the route distributors worked. In 1991, petitioner issued at least one route distributor, Frank Barranco, a Form W-2. In 1992, petitioner did not issue Forms 1099 to any of petitioner's 21 route distributors.”

**The firm informed its work force** that any “employees not wishing to become independent contractors would be discharged prior to January 1, 1992.”

“The outside sales workers were individuals who marketed petitioner's product. They had their own vehicles, and petitioner did not set their hours. When an outside sales worker sold a product, he was paid a commission. Petitioner had the right to hire and fire the outside sales people. In 1991, petitioner issued at least two outside sales workers, Terre Cone and Terry McKnight, a Form W-2. In 1992, two of petitioner's five outside sales workers received Forms 1099. Of the three who did not receive a Form 1099, two earned less than \$600. On November 4, 1991, petitioner issued a memorandum from Ewens to the staff. The memorandum stated: (1) The company had treated certain workers as employees and others as independent contractors; (2) beginning January 1, 1992, petitioner would discontinue its production function and would subcontract its entire operations to outside groups or individuals; (3) individuals who wanted to continue their association with petitioner would be required to sign a statement in which they accepted responsibility for all of their own payroll taxes; (4)

individuals would be issued Forms 1099 instead of Forms W-2; and (5) employees not wishing to become independent contractors would be discharged prior to January 1, 1992.”

**The firm reported no salaries and wages in 1992 issuing 36 Forms 1099-MISC reporting total payments of \$115,287.05.**

“After January 1, 1992, there was no change in the activities petitioner's workers performed (i. e., in 1992, the workers did much of the same work). The reason petitioner wanted to convert its employees to independent contractors was to protect petitioner from lawsuits and to have better control over the activities of its workers. Petitioner was advised by an attorney to convert the employees to independent contractors to limit petitioner's liability. Petitioner continued directly paying its workers. Several of petitioner's checks issued to its workers, and signed by Miller, in 1992 bear the notation ‘payroll’. Additionally, there was a debit slip dated July 3, 1992, for petitioner's bank account that noted that cash was withdrawn for payroll. For 1991, petitioner reported salaries and wages of \$196,433 on its Federal corporate income tax return, and it issued 51 Forms W-2 to its employees reporting total wages of \$196,432.60. Petitioner also reported \$81,143 of subcontractual labor, and it issued 10 Forms 1099-MISC reporting total payments of \$37,930.74. For 1992, petitioner reported no salaries and wages on its Federal corporate income tax return. Petitioner reported \$115,287 of subcontractual labor, and it issued 36 Forms 1099-MISC reporting total payments of \$115,287.05.”

**The Form 941 for the last quarter of 1992 reported that the firm had no employees “and that it was out of business.”**

“Petitioner filed Forms 941, Employer's Quarterly Federal Tax Return, for the four quarters of 1992 and reported no wages subject to withholding, no withheld income tax, no Social Security tax, and no Medicare tax. Petitioner's Form 941 for the last quarter of 1992 reported that the date final wages were paid was December 31, 1991, that it had no employees, and that it

was out of business. Petitioner's Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, for 1992 also reported no wages, that petitioner had no employees, and that it was out of business. Respondent determined that the bakery workers, cash payroll workers, route distributors, and outside sales workers were employees for employment tax purposes for 1992. Respondent further determined that petitioner was not entitled to section 530 relief for any of these workers. Respondent also determined penalties pursuant to section 6656.”

**The “route distributors” were found by the court to be common law employees.**

“After considering the record as a whole, weighing all of the factors, and being cognizant that doubtful questions should be resolved in favor of employment, we conclude that the cash payroll workers, bakery workers, and outside sales workers were common law employees. Upon the basis of this record, however, we do not find the route distributors to be common law employees. 8 Therefore, we must decide whether the route distributors were statutory employees. See sec. 3121(d)(3); Lickliss v. Commissioner, T.C. Memo. 1994-103. For the purposes of employment taxes, the term ‘employee’ also includes individuals who perform services for remuneration as an agent-driver or commission-driver engaged in distributing bakery products. Sec. 3121(d)(3)(A). Substantially all of these services must be performed personally by such individual. Sec. 3121(d)(3) (flush language). Individuals are not included in the term ‘employee’ under section 3121(d)(3) if the individual has a substantial investment in the facilities used in connection with the performance of such services (other than facilities for transportation), or if the services are in the nature of a single transaction.”

**Though common law independent contractors, the route distributors were found to be statutory employees under IRC 3121(d)(3).**

“The regulations provide that agent-drivers and commission-drivers include individuals who operate their own truck, serve

**“After considering the record as a whole \*\*\* we conclude that the cash payroll workers, bakery workers, and outside sales workers were common law employees.”**



customers designated by the person for whom they perform services and customers solicited on their own, and whose compensation is a commission on their sales or the difference between the price they charge the customers and the price they pay for the product or service. Sec. 31.3121(d)-1(d)(3)(i), Employment Tax Regs. The route distributors fit within the definition of agent-driver and commission-driver provided in the Code and regulations. They each performed substantially all the distribution of bakery products for petitioner. The route distributors did not have a substantial investment in the facilities other than those used for transportation. The record does not establish that their services were in the nature of a single transaction. The route distributors served customers designated by petitioner as well as those they solicited on their own, and their compensation was either a commission on their sales or the difference between the price they charged and the price they paid for petitioner's bakery products. Therefore, we conclude that the route distributors were statutory employees."

**A taxpayer is entitled to section 530 relief** "if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee."

"Congress enacted section 530 to alleviate what it perceived as the 'overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors.' *Boles Trucking, Inc. v. United States*, 77 F.3d at 239. Thus, despite our conclusion that the cash payroll workers, bakery workers, route distributors, and outside sales workers were employees of petitioner, and that the payments to them from petitioner were wages subject to Federal employment taxes, section 530 allows petitioner relief from employment tax liability if two conditions are satisfied. Section 530(a)(3) further clarifies section 530(a)(1) by providing that if the 'taxpayer (or a predecessor)' treated any individual holding a 'substantially similar position as an employee', then section 530 relief is not available to the taxpayer. Sec. 530(a)(1), (3). We note that the statute does not require the individuals to be identical; rather, the analysis focuses on whether individuals were in substantially similar positions. For purposes of section 530(a)(1), a taxpayer is treated as having a reasonable basis for not treating an individual as an employee if the taxpayer's treatment of the

individual was in reasonable reliance on (1) judicial precedent, (2) published rulings, (3) technical advice with respect to the taxpayer, (4) a letter ruling to the taxpayer, (5) a past IRS audit of the taxpayer if the audit entailed no assessment attributable to the taxpayer's employment tax treatment of individuals holding positions substantially similar to the position held by the individual whose status is at issue \* \* \*."

**The firm did not qualify for relief under the safe-haven.**

"Prior to 1992, petitioner treated all of its production workers (cash payroll workers and bakery workers) as employees. Prior to 1992, petitioner treated at least one route distributor and at least two outside sales workers as employees. \* \* \* Petitioner did not demonstrate that it reasonably relied upon judicial precedent, published rulings, technical advice, a letter ruling, or a past audit. Petitioner argues that it relied on a longstanding practice in the industry in which it was engaged -- 'co-packing'. 'Co-packing' is where a company does not produce its product itself; it hires others to produce its goods for it. Petitioner presented no evidence, however, on how the practice of co-packing related to the treatment of its workers as employees. Furthermore, petitioner did not offer any witnesses to testify about an industry practice of co-packing and the treatment of 'co-packers' as independent contractors. \* \* \* We conclude that petitioner had no reasonable basis for treating the bakery workers, cash payroll workers, route distributors, and outside sales workers as independent contractors."

**Comment:** Changing from mostly employees to all independent contractors, using the same workers with no material change in circumstances, is a recipe for employment tax disaster. The firm argued that the switch was done with the advice of counsel but the name of the attorney is missing, as is any writing from the unknown counselor.

**Source:** Ewens and Miller, Inc. v. Commissioner of Internal Revenue, 117 T.C. No. 2 (U.S. Tax Court, Docket No. 13069-99, December 11, 2001). ⌘

**COURT HELD IRS SHOULD HAVE GRANTED SECTION 530 SAFE-HAVEN RELIEF**

**Hospital treated certain physicians as independent contractors.**

**Hospital relied on advice of both in-house and outside counsel.**

**Plaintiff North Louisiana Rehabilitation Center, Inc. sued** the United States of America (IRS) “seeking a refund of employment taxes” paid after an assessment based on a determination that certain physicians should have been treated as employees rather than as independent contractors.

**The IRS assessed employment and unemployment taxes** in an amount exceeding \$217,000.

“Plaintiff, a Louisiana corporation, is one of several majority owned subsidiaries of Continental Medical Systems, Inc. (“CMS”), which operates freestanding for-profit rehabilitation hospitals. In order to provide guidance on medical issues and the establishment of rehabilitation programs, as well as to assure the availability of medical staffing, Plaintiff contracted with various physicians to serve as medical directors and program directors (‘the Physicians’). The Physicians were treated as independent contractors for employment tax purposes. That is, Plaintiff did not pay the employer’s share of the Physicians’ federal employment or unemployment taxes, or withhold federal income tax from their compensation. Following an employment tax audit for the 1990 through 1995 tax years, the IRS determined that the Physicians should have been treated as employees rather than independent contractors, and assessed employment and unemployment taxes against Plaintiff in the amount of \$217,799.53. After an unsuccessful administrative appeal, Plaintiff filed amended employment and unemployment tax returns, paid a portion of the tax due, and filed a claim for refund and request for abatement for each of the amended returns. The IRS failed to act on Plaintiff’s refund and abatement claim within the six-month period set

forth in I.R.C. § 6532(a). As a result, Plaintiff filed the instant suit seeking a refund of \$7,010.90 paid to the IRS. Defendant filed a counterclaim seeking the total amount of the assessment.”

**The government argued that** the firm does not qualify for relief under section 530 because “questions of fact remain regarding whether doctors holding substantially similar positions to the Physicians were treated as employees.”

“Plaintiff contends that regardless of whether the Physicians were employees or independent contractors under the common law test, it is entitled to the safe harbor provisions of Section 530 because all medical directors and program directors have been treated as independent contractors, all tax forms filed by Plaintiff have been consistent with its treatment of the Physicians as independent contractors, and it had a reasonable basis for treating the Physicians as independent contractors. Defendant contends that Plaintiff may not avail itself of Section 530 because questions of fact remain regarding whether doctors holding substantially similar positions to the Physicians were treated as employees. Defendant further contends that Plaintiff did not have a reasonable basis for treating the Physicians as independent contractors.”

**The government further argued that** treating Dr. Hearn, a staff physician, as an employee “creates a factual question as to whether Plaintiff has met the substantive consistency requirement.”

“In order for Plaintiff to avail itself of Section 530, it must establish that it ‘has [not] treated any individual holding a substantially similar position as an employee for purposes of the employment taxes. . . .’ *Id.* at (a)(3). Defendant acknowledges that all medical and program directors retained by Plaintiff were treated as independent contractors. However, Defendant contends that Plaintiff’s employment of Dr. Hearn as a staff physician creates a factual question as to whether Plaintiff has met the substantive consistency requirement since 1993 because her position was substantially similar to that of a medical director. According to Defendant, medical directors are responsible for administrative and consultative oversight of the rehabilitation programs and

**“In order for Plaintiff to avail itself of Section 530, it must establish that it ‘has [not] treated any individual holding a substantially similar position as an employee for purposes of the employment taxes.”**



for ensuring that the programs are of high quality. Their responsibilities include 1) developing programs for patient care; 2) ensuring that the therapists, staff doctors, and nurses are meeting their job standards; 3) sitting on various committees; 4) ensuring that the hospital maintains its accreditations; 5) presenting educational programs to the staff; 6) marketing the hospital's services to the community; 7) developing hospital rules and by-laws; 8) resolving disputes; and 9) selecting new or replacement equipment. Medical directors generally spend between 35 to 40 hours per week on these duties and earn approximately \$100,000 to \$125,000 per year. Defendant further contends that Dr. Hearn was required to spend 40 hours per week on administrative duties which included serving on committees, assisting with patient care policies, protocols, and quality assurance programs, and consulting with administrative and medical staff on program development and the quality of care."

**The Court agreed with the firm** and recognized a distinction between Dr. Hearn and the medical directors.

"Plaintiff contends that the substantive consistency requirement is met. According to Plaintiff, Defendant conceded that this requirement was met when it admitted on October 5, 2000, that '[w]ith respect to Medical Directors, plaintiff has met the substantive consistency test for relief pursuant to Section 530 of the Revenue Act of 1978,' and '[w]ith respect to Program Directors, plaintiff has met the substantive consistency test for relief pursuant to Section 530 of the Revenue Act of 1978.' See Plaintiff's First Request for Admissions Addressed to Defendant United States of America and Defendant's Response to Plaintiff's First Request for Admissions, 9 and 13. Alternatively, Plaintiff contends that Dr. Hearn's position was not substantially similar to that of a medical director. According to Plaintiff, Dr. Hearn was retained as a full-time attending physician. She was required to devote at least 130 hours per month to clinical care and at least 40 hours per month to administrative duties. Further, Dr. Hearn's schedule was determined by the hospital and she was not to be employed elsewhere or maintain a private practice. Plaintiff argues that, in contrast, medical directors devote less time to the hospital, their role is primarily consultative, they have their own private practices, and the hospital does not dictate the means or manner of their work. For the reasons stated earlier, the Magistrate Judge's Order granting Defendant's

Second Motion for Leave to Withdraw or Amend Admission is affirmed, and Defendant's admission of Request No. 9 is withdrawn. Thus, the Court must determine whether the substantive consistency requirement is met in light of this Ruling. The Court finds that there is no genuine issue of material fact that Dr. Hearn's position was not substantially similar to that of a medical director. Although Dr. Hearn was required to devote time to administrative duties, some of which overlapped with the duties of medical directors, she spent an average of ten hours per week on these duties as compared to the 35 to 40 hours per week spent by the medical directors. Further, the nature of the hospital's control over Dr. Hearn's schedule and duties was very different from that exercised over the medical directors."

**The firm relied** on "local counsel for advice on the treatment of medical and program directors."

"Plaintiff contends that it relied on the advice of counsel in determining how to treat the Physicians. According to Plaintiff, all of the contracts in question were reviewed and approved by legal personnel affiliated with CMS, including CMS's legal counsel, Deborah Myers Welsh ('Welsh'). Also, Plaintiff contends that CMS's management relied on the advice of both outside and in-house counsel in determining its subsidiaries' treatment of medical and program directors. According to Anthony F. Misitano ('Misitano'), a CMS executive who signed contracts with physicians on behalf of Plaintiff, the CMS legal department would consult with local counsel in order to ensure that the contracts were consistent with state law. Thus, every contract presented to him for signature was reviewed by both outside and in-house counsel and he relied completely on their views and recommendations. Plaintiff also contends that Welsh frequently consulted with outside counsel in drafting and approving contracts between CMS's subsidiaries and their physicians. Specifically, Plaintiff asserts that Welsh often consulted with Harvey Werblowsky ('Werblowsky'), an attorney with the law firm of McDermott, Will and Emery, which served as CMS's outside counsel. Welsh testified that she and Werblowsky discussed various IRS rulings, reviewed the '20 factors' common law test, and concluded that the medical and program directors clearly fell into the independent contractor category. Finally, Plaintiff contends that Welsh relied on local counsel for advice on the treatment of medical and program directors, and these

attorneys were often asked to prepare or review contracts in order to ensure their compliance with state law. Defendant contends that Plaintiff is not entitled to summary judgment because Plaintiff has not offered sufficient evidence regarding the information provided to these attorneys, the research undertaken by these attorneys, or the specific advice rendered by these attorneys. The Court concludes that no genuine issues of fact exist and Plaintiff is entitled to relief under Section 530. First, all medical and program directors retained by Plaintiff were treated as independent contractors. Second, Plaintiff filed all required federal tax returns on a basis consistent with its treatment of the Physicians as independent contractors. Finally, Plaintiff and CMS reasonably, and in good faith, relied on the advice of in-house and outside counsel in making the decision to treat the Physicians as independent contractors.”

**Comment:** If the government had insufficient basis to deny safe-haven relief, the firm is entitled to attorney fees.

**Source:** North Louisiana Rehabilitation Center, Inc. v. U.S., 88 AFTR2d Par. 2001-5589 (U.S. District Court, Western District of Louisiana, Docket No. 00-0445, November 7, 2001). ⌘

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— From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

**TABLE OF RECENTLY REPORTED CASES AND RULINGS INVOLVING THE INDEPENDENT CONTRACTOR ISSUE**

No.	Type of Worker	Result & Brief Description	Type of Case or Ruling	Legal Citation
931	Exotic dancers, nude dancers	Appeals Court overruled lower court and awarded attorney's fees to nightclub after finding IRS had insufficient basis to assess the employment taxes.	Federal employment tax, IRC 7430, 6041; section 530, Revenue Act of 1978	Deja Vu-Lynnwood, Inc., fka Pam Jam Enterprises, Inc. v. United States, 88 AFTR2d Par. 2001-5554 (U.S. Court of Appeals, Ninth Circuit, Docket No. 99-35832, October 26, 2001).
930	Physicians serving as medical directors and program directors	Hospital treating certain physicians as ICs relied on advice of both in-house and outside counsel. Court held IRS should have granted section 530 safe-haven relief.	Federal employment tax, section 530 of Revenue Act of 1978	North Louisiana Rehabilitation Center, Inc. v. U.S., 88 AFTR2d Par. 2001-5589 (U.S. District Court, Western District of Louisiana, Docket No. 00-0445, November 7, 2001).
929	Bakery production workers, bakery goods route distributors	Firm treated virtually everyone at bakery as employees in 1991. In 1992, bakery changed to independent contractor treatment with little change in facts. IRS determined workers were still employees. Court agreed.	Federal employment tax, IRC 3121(d)(2), 3121(d)(3)	Ewens and Miller, Inc. v. Commissioner of Internal Revenue, 117 T.C. No. 22 (U.S. Tax Court, Docket No. 13069-99, December 11, 2001).
928	Workers in general, scope of Tax Court jurisdiction	IRC 7436(e) does not exclude additions to tax and penalties from employment tax. Neither does 6665(b). IRS held Tax Court has power to determine amount of tax and additions.	Federal employment tax, IRC 6665(b), 7436(e) [Tax Court jurisdiction]	IRS Chief Counsel Notice CC-2001-044 (October 4, 2001).
927	President of Subchapter "S" corporation, drywall construction	Owner of Subch. "S" drywall construction co. held recipient of wages not dividends. No regular payments made to pres. who withdrew money from co. at his discretion. Co. did not issue 1099s or W-2s for three years in question.	Federal employment tax, IRC 3121(d)(2), 7436, section 530 of the Revenue Act of 1978	Yeagle Drywall Company, Inc. v. Commissioner of Internal Revenue, T.C. Memo. 2001-284 (United States Tax Court, October 15, 2001).
926	Tax collector for town, public official	IRS held town tax collector an employee though he kept an office, employed two clerical employees, paid rent, utilities, and office equipment. As a "public official" worker was statutory employee for income tax withholding.	Federal employment tax, IRC 3121(d)(2), 3401(c)	IRS Private Letter Ruling 200146006 (Document date: May 22, 2001; Release date November 16, 2001).
925	Couriers and messengers receiving two checks - one W-2 type and one 1099 type	Courier and messenger firm assessed over \$450,000 for unpaid employment taxes. IRS disagreed with two-check method splitting payments into wages and non-wage vehicle reimbursement.	Federal employment tax, IRC 62, 3121(d)	Shotgun Delivery, Inc. v. United States, 88 AFTR2d Par. 2001-5418 (United States Court of Appeals, Ninth Circuit, October 16, 2001).
924	Pilot of vessel	Worker and his corporation provided pilot services to vessels in ports. IRS held amounts the corporation paid to pilot / ex-shareholder in 1995 and 1996 were wages subject to FICA and FUTA.	Federal employment tax, IRC 3121	IRS FSA 200133009 (IRS National Office Field Service Advice, Release Date: August 17, 2001; Document Date: May 4, 2001).
923	Cruise vessel / ship workers	Services performed on the vessel by workers who are not citizens do not constitute employment under section 3121(b)(4) for purposes of FICA taxes imposed by sections 3101 and 3111.	Federal employment tax, IRC 3121(b)(4), 3306(c)(4)	IRS Private Letter Ruling 200136019 (Release Date: September 7, 2001; Document Date: June 11, 2001).
922	Oilfield rig welders	Oilfield rig welders treated as ICs and paid rig rental payments. IRS said not enough information to tell worker status. However, if the workers were employees, then so-called rig rental payments were wages for employment tax purposes.	Federal employment tax, IRC 3121(d)	IRS FSA 200127004 (Internal Revenue Service National Office Field Service Advice; Release Date: July 6, 2001; Document Date: March 19, 2001).

**ABOUT THIS COMPILATION:**

Each month, this table brings together significant reported State and Federal cases, rulings, statutes and other employment tax related documents bearing on the independent contractor issue. To compile this table, each month we screen thousands of new court decisions and administrative rulings.