The Employee/Independent Contractor Classification: Do Loan Officers Working with California Mortgage Brokers Qualify As Statutory Independent Contractors?

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The Employee/Independent Contractor Classification: Do Loan Officers Working With California Mortgage Brokers Qualify As Statutory Independent Contractors?*

In ascertaining federal employment tax liabilities, companies must determine whether the individuals they work with are employees or independent contractors. In this process, companies apply a common law test, and some can apply Internal Revenue Code section 3508. Section 3508 qualifies real estate agents and direct sellers as statutory independent contractors. This Comment addresses whether loan officers working with California mortgage brokers satisfy the elements of Internal Revenue Code section 3508 and fall within the definition of “real estate agent.”

TABLE OF CONTENTS

I. INTRODUCTION ........................................................................................................ 896
II. INDEPENDENT CONTRACTORS AND THEIR ROLE IN THE ECONOMY ........... 900
   A. Size of the Independent Contractor Sector ....................................................... 901
   B. Function of Independent Contractors ................................................................. 902
III. THE FEDERAL EMPLOYMENT TAX REGULATIONS, THEIR DEFINITIONS FOR EMPLOYEES, AND THE COMMON LAW AND STATUTORY EXEMPTIONS FOR INDEPENDENT CONTRACTORS ........................................... 903
IV. THE IRS AUDIT ....................................................................................................... 905
   A. The IRS Audit and the Ramifications of Reclassification ................................. 905
   B. The Motivation for the Audit: Perceived Problems with the Use of the Independent Contractor Classification .................. 907

* Special thanks to Michael J. Kinkelaar for his valuable insights into the state of the law in this area, and to Prof. Lester Snyder for his guidance and assistant with this Comment.
V. THE CASE OF CALIFORNIA MORTGAGE BROKERS AND THEIR LOAN OFFICERS ........................................... 910

VI. THE COMMON LAW APPROACH TO THE CLASSIFICATION ......................................................... 914
   A. Federal Common Law ........................................................................................................ 914
      1. The Factors .................................................................................................................. 915
      2. Application of the Factors .......................................................................................... 918
      3. Federal Common Law Conclusions .......................................................................... 925

VII. THE STATUTORY EXEMPTION ARGUMENT ........................................................................... 926
   A. Legislative History of the Statutes ................................................................................. 926
   B. Section 530 ...................................................................................................................... 928
   C. Section 3508 and California Loan Officers ................................................................. 929
      1. The Elements of Section 3508 ..................................................................................... 929
      2. Application of the Elements of Section 3508 .............................................................. 930
      3. Potential Problems with the Application of 3508 ....................................................... 931
      4. Definition of Activities of a Real Estate Agent .............................................................. 931
      5. Federal Adoption of the State Rule .......................................................................... 932
      7. Order of Enactment ....................................................................................................... 937
      8. Conclusions ................................................................................................................... 937
   D. The Proposed Regulations to Section 3508 .................................................................... 938
      1. Persuasive Power of Proposed Regulations ................................................................. 938
      2. Interpreting the Proposed Regulations ........................................................................ 939
         a. Plain and Ordinary Meaning of the Words ................................................................. 940
         b. Expressio Unius Est Exclusio Alterius .................................................................... 941
         c. Specific Exclusion ....................................................................................................... 942
      3. Conclusions Regarding the Proposed Regulations ..................................................... 943
   D. Further Analysis of Section 3508—The Purpose ............................................................. 943
   F. Conclusions Regarding Section 3508 .............................................................................. 944

VIII. RECOMMENDATION TO THE IRS .................................................................................... 945

IX. CONCLUSION ..................................................................................................................... 945

I. INTRODUCTION

In virtually every agreement or relationship where one party will conduct work for another, the person requesting the work must determine whether the other party is an independent contractor or an employee. If the party requesting the work concludes that the other party is an employee, then the requesting party—the employer—is responsible for three types of federal employment-related taxes.1 However, if the requesting party determines that the other party is an independent contractor, then the party requesting the work is not

1. Employers are responsible for three types of employment related taxes under the Federal Employment Tax Regulations: 1) tax under the Federal Insurance Contributions Act (FICA); 2) tax under the Federal Unemployment Tax Act (FUTA); and 3) federal withholding taxes. These taxes are explained in detail infra part III. The employer is actually paying the FICA and FUTA taxes, but is merely withholding the federal income tax for the government which is actually being paid by the employee.
considered an employer and is thus not responsible for these federal employment related taxes.\textsuperscript{2}

In making the determination of whether a particular worker is an employee or an independent contractor for federal employment tax purposes, the parties involved must look to the Internal Revenue Code (IRC) for guidance.\textsuperscript{3} For a narrow class of workers, this classification is easy because the IRC specifically sets forth how they are to be treated for employment tax purposes.\textsuperscript{4} For the majority of workers, however, the IRC provides little guidance.\textsuperscript{5}

California mortgage brokers and their loan officers are one group that has been given little guidance by the IRC.\textsuperscript{6} The IRC does not address mortgage brokers or loan officers explicitly. Mortgage brokers and loan officers are thus forced to apply a rather complex and fact specific common law test to determine whether loan officers working with California mortgage brokers qualify as employees or independent contractors.\textsuperscript{7} In one Revenue Ruling and one Private Letter Ruling the Internal Revenue Service (IRS) has held that loan officers working with

\begin{itemize}
\item \textsuperscript{2} If the worker is an independent contractor, the requesting party is no longer obligated to pay FICA and FUTA taxes. Further, the requesting party is no longer required to withhold federal income tax payable from the worker to the federal government. The burden for the income tax payments shifts to the independent contractor. The independent contractor is required to make quarterly installments toward her estimated income tax liability for the year. This process is explained infra part III.
\item \textsuperscript{3} \textit{See supra} note 1. The employer is responsible for three employment related taxes and must look to the pertinent IRC sections to determine if they are required to pay these taxes. The pertinent sections are: I.R.C. §§ 3121, 3306, 3401 (1994). These IRC sections are described in detail infra part III.
\item \textsuperscript{4} For example, real estate agents and direct sellers are specifically addressed in I.R.C. § 3508 (1994). The statute specifically states that they shall not be treated as employees. \textit{See infra} note 13.
\item \textsuperscript{6} For an explanation of the relationship between mortgage brokers and loan officers, see infra part V.
\item \textsuperscript{7} For a discussion of the statutes requiring the application of the common law test, see infra part III. For a discussion and application of the common law test and its 20 factors, see infra part VI.
\end{itemize}
mortgage brokers are employees under the common law test. However, these rulings were based on the particular facts of those two cases which made it rather clear that the particular loan officers involved were employees. Accordingly, these two rulings provide mortgage brokers and loan officers with little guidance in applying the common law test and determining the proper classification for loan officers. As a result, some mortgage brokerage firms have classified their loan officers as employees and other brokerages have classified their loan officers as independent contractors.

The problem with this uncertain situation is that the IRS is now targeting mortgage brokerage firms for audits, claiming the firms have improperly classified their loan officers as independent contractors. With an IRS-ordered reclassification comes assessments of fines and penalties regardless of whether the brokerage firm had a good faith belief that their loan officers were independent contractors. Some of these potential fines are substantial, with the possibility that the liability for the assessments will fall personally on the directors or officers of the mortgage brokerage firms.

In response to these audits, some mortgage brokerage firms are arguing their loan officers qualify as statutory independent contractors under IRC section 3508 regardless of the results under the common law test. Some mortgage brokers are arguing their loan officers satisfy

9. See cases cited supra note 8.
10. For a discussion of this issue, see infra part V.
11. For a discussion of these penalties, see infra part IV.
12. For an example, see infra part V.
13. The pertinent portions of I.R.C. § 3508 are as follows:
   (a) General rule. For purposes of this title, in the case of services performed as a qualified real estate agent or as a direct seller—
      (1) the individual performing such services shall not be treated as an employee....
   (b) Definitions. The term “qualified real estate agent” means any individual who is a sales person if—
      (A) such individual is a licensed real estate agent,
      (B) substantially all of the remuneration for the services performed by such individual as a real estate agent is directly related to sales or other output (including the performance of services) rather than to the number of hours worked, and
      (C) the services performed by the individual are performed pursuant to a written contract between such individual and the person for whom the services are performed and such contract provides that the individual will not be treated as an employee with respect to such services for Federal tax purposes.
the elements of IRC section 3508 and fall within the definition of "real estate agent." The IRS has not responded to this statutory argument. The IRS issued Revenue Ruling 57-402 prior to 1982, the year Congress enacted IRC section 3508. Therefore, the IRS did not consider the statute in its analysis of that case. Further, although the IRS issued the Private Letter Ruling addressing mortgage brokers and loan officers after the enactment of IRC section 3508, the IRS did not address the statutory argument. The IRS analysis dealt only with the common law test. Therefore, the statutory argument for independent contractor status for loan officers appears to be one of first impression for the IRS.

The author’s purpose in this Comment is to evaluate the issue of whether loan officers working with California mortgage brokers qualify for classification as statutory independent contractors under IRC section 3508 for federal employment tax purposes. In the first four sections the author sets forth the background of this issue. In Part Two, the author addresses the size of the independent contractor segment and their function in the economy. In Part Three, the author sets forth the pertinent federal employment tax regulations. The author also outlines the common law and statutory exemptions to these employment tax regulations. In Part Four, the author discusses the IRS audit and the ramifications of a reclassification by the IRS. This discussion includes an explanation of the IRS’s motivation behind their reclassification efforts. In Part Five, the author discusses the importance of the independent contractor classification issue for California mortgage brokers and their loan officers with particular concern for San Diego.


14. It is uncertain whether the IRS has not responded because the argument has not been raised in a request for a Private Letter Ruling or whether the requests have been made and the IRS has simply refused to address the argument. The author hopes this Comment will encourage a party to make a ruling request and also encourage the IRS to issue a ruling on the issue.


18. Id. Most likely, the IRS did not address the statutory argument because the argument was not raised by the attorneys in that case.

19. This Comment focuses on San Diego mortgage brokers and loan officers since the Comment is written for the San Diego Law Review. The author’s analysis also highlights the problem in San Diego because this is currently an important issue in San Diego.
This discussion includes an explanation of the relationship between mortgage brokers and loan officers. In Part Six, the author analyzes the IRS’s common law approach to determining the classification of loan officers working with mortgage brokers. This analysis includes an explanation of the twenty-factor common law test and of the relevance of the IRS’s Revenue Ruling and Private Letter Ruling regarding loan officers under this test. Also, the author applies the twenty common law factors to the situation of loan officers working with mortgage brokers.

In Part Seven, the author analyzes in detail the statutory exemption argument under IRC section 3508. Finally, in Part Eight, the author recommends that the IRS issue a Private Letter Ruling or a Revenue Ruling stating whether loan officers working with mortgage brokers qualify as statutory independent contractors under section 3508 for federal employment tax purposes.

II. INDEPENDENT CONTRACTORS AND THEIR ROLE IN THE ECONOMY

This Comment is concerned with the federal employment tax implications of the employee/independent contractor classification. These federal employment tax regulations are set forth in detail in Part III of this Comment. However, before addressing the regulations themselves, it is important the reader understand what independent contractors are and the role they play in the economy.

An independent contractor is “one who, in exercise of an independent employment, contracts to do a piece of work according to his own methods and is subject to his employer’s control only as to end product or final result of his work.” Although there are numerous definitions of an independent contractor, it is often quite difficult to determine

Diego. The topic has received recent attention in newspaper and journal articles in San Diego. However, the analysis applies to mortgage brokers outside the San Diego area as well.


21. A party will have to request a ruling before the IRS will respond. The recommendation in part VIII, infra, encourages the IRS to respond if such a request is made.

22. BLACK’S LAW DICTIONARY 693 (5th ed. 1979) (citing Hammes v. Suk, 190 N.W.2d 478, 480-81 (Minn. 1971)).

who is an independent contractor and who is an employee. However, as will be shown below, it is not difficult to understand the importance of independent contractors to the U.S. economy.

A. Size of the Independent Contractor Sector

The number of independent contractors in the U.S. economy is some indication of their importance. A study conducted for the Small Business Association by Berkeley Planning Associates, sheds light on the number and use of independent contractors. The study concluded that there are approximately five million independent contractors in the economy, and approximately thirty-one percent of all employers in the sample, or 2,006,000 firms, used them. With so many firms using independent contractors, it is important to understand the role these contractors play.

York, 168 So.2d 107, 112 (La. App. 1964)).

"An independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking."

RESTATEMENT (SECOND) OF AGENCY § 2 (1957).

"One who makes an agreement with another to do a piece of work, retaining in himself control of means, method and manner of producing the result to be accomplished, neither party having the right to terminate the contract at will." BARRON'S LAW DICTIONARY 98 (3rd ed. 1991) (quoting Heffner v. White, 45 N.E.2d 342, 345 (Ind. App. 1942)).

24. The focus of this Comment is the classification of independent contractors for tax purposes. Some of the definitions referred to in the previous footnote do not specifically relate to tax treatment. The definitions are provided to give the reader an understanding of what an independent contractor is without listing statutes or enunciating the 20 common law factors to determine whether a worker is an independent contractor for tax purposes.

25. The Small Business Association (SBA) released this study in June of 1991. The original data for the study was based on a mail and telephone survey of 724 companies, conducted between April and June 1990. Impact on Independent Contractor Reclassification on Small Business: Hearing Before the Subcommittee on Exports, Tax Policy and Special Problems, 102d Cong., 1st Sess. 68, 73-74 (1991) (testimony of Mark S. Hayward, SBA Acting Chief Counsel, and Dan Mastromarco, SBA Assistant Chief Counsel for Tax Policy), microformed on CIS No. 92-H721-35.3 (Congressional Info. Serv.) [hereinafter Hearing].

26. Id. at 74.
B. Function of Independent Contractors

Independent contractors are not only a sizable, permanent, and growing segment of the U.S. economy, they also contribute to America’s increased competitiveness in national and world markets because they fill a necessary void.\(^{27}\) This void was created because although some people wanted to enter the labor market and others needed work to be done, those in need of labor services did not want or need additional employees.\(^{28}\) Apparently, the independent contractor relationship allowed all parties to satisfy their needs because work could be done while avoiding the formalities and obligations of an employment relationship.\(^{29}\) Thus, the growth of independent contractors has been spurred on by both labor supply and business demand factors.\(^{30}\)

On the supply side, contingent work has been affected by the entry of women with children into the work force.\(^{31}\) Other groups attracted to contract labor include students, elderly people, “moonlighters” who want to increase their earnings, and people looking for full-time work or on a temporary layoff.\(^{32}\) Another supply factor is the rapid spread of temporary agencies, business service contractors, and staffing leasing firms that are able to act as efficient labor market intermediaries.\(^{33}\)

On the demand side, contingent workers, such as independent contractors, allow employers to meet fluctuating work needs caused by short-term shifts in demand, implement new technologies, and perform other specialized work to circumvent hiring freezes.\(^{34}\) These workers also allow employers to reduce administrative burdens and cost, protect core workers from layoffs, screen prospective candidates for regular job positions, and increase the available labor pool in labor shortage areas.\(^{35}\)

Therefore, the independent contractor relationship benefits the contractors themselves, the companies with which they contract, and the

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\(^{27}\) Id.

\(^{28}\) Those in need of labor may not have needed an employee because they only needed one specific project completed. Id. at 74-75. They may not have wanted an employee due to the costs associated with an employee. These costs include the administrative costs of managing an employee, as well as the costs of providing benefits to an employee. Id. at 75.

\(^{29}\) See id. at 74.

\(^{30}\) Id.

\(^{31}\) Id.

\(^{32}\) Id.

\(^{33}\) Id.

\(^{34}\) Id. at 75.

\(^{35}\) Id.
economy as a whole. To classify a worker as an independent contractor for federal employment tax purposes, the worker must satisfy the legal requirements of the pertinent regulations.

III. THE FEDERAL EMPLOYMENT TAX REGULATIONS, THEIR DEFINITIONS FOR EMPLOYEES, AND THE COMMON LAW AND STATUTORY EXEMPTIONS FOR INDEPENDENT CONTRACTORS

The classification of workers as employees or independent contractors impacts over twenty different sections of the Internal Revenue Code (IRC) and has international ramifications through various treaties.36 This Comment is concerned with the federal employment tax regulations of the employee/independent contractor classification.

Employers who classify their workers as employees are legally responsible for three types of employment-related taxes under the Federal Employment Tax Regulations.37 First, under the Federal Insurance Contributions Act (FICA), a tax is imposed on employers and employees that is used to fund the Social Security System.38 Second, under the Federal Unemployment Tax Act (FUTA), a tax is imposed on employers and employees to fund the Federal Unemployment Insurance Program.39 Third, under IRC sections 3401 through 3404, federal withholding tax must be deducted by employers from their employee's compensation and forwarded to the government.40 The amount withheld is credited against the amount of income taxes that the employee must pay on income earned for the taxable year.

These three types of federal employment taxes must be withheld by the employer if the worker is an employee. However, if the worker is determined to be an independent contractor, these taxes are not withheld. The independent contractor receives full compensation from the employer and the employer is merely required to file an informational return describing the amount of compensation paid to the independent contractor.41 This informational return is known as a Form 1099. The

37. Hearing, supra note 25, at 76.
41. Hearing, supra note 25, at 76-78.
independent contractor is then required to pay income taxes on the amount disclosed in the informational return, but this becomes the independent contractor's responsibility, not the employer's. Independent contractors are required to make quarterly estimated deposits to their estimated income tax liabilities.  

Guidelines for determining whether a worker is an employee are found in three substantially similar sections of the Internal Revenue Code: 1) IRC section 3121(d)(2) of the Federal Insurance Contributions Act (FICA); 2) IRC section 3306(i) of the Federal Unemployment Tax Act (FUTA); and IRC section 3401(c), relating to federal income tax withholding. Section 3121(d)(2) states that the term "employee" means "any individual who, under the usual common law rules applicable to determining the employer-employee relationship, has the status of an employee." Section 3306(i) incorporates this same definition. Section 3401(c) appears to implicitly adopt the definition of 3121(d) and adds to the definition of an "employee" any officers, employees, or elected officials of the United States, a State, or the District of Columbia. Therefore, the common law factors appear to be the test under all three sections.

If the worker is determined to be an employee under the common law test, then the three previously-mentioned taxes must be withheld from the employee's compensation. However, if after applying the common law factors the worker is determined to be an independent contractor, then no taxes must be withheld. Therefore, there is a common law exemption from these three employment taxes for workers who can satisfy the common law test and be deemed independent contractors.

42. Id. at 76-77. Compensation paid to independent contractors is subject to the tax on self-employment income (SECA), but not to FICA or FUTA taxes. The SECA tax is paid only by the self-employed individual. Id. at 76-77, 85.

43. I.R.C. § 3121(d) (1994) reads in part: "For purposes of this chapter, the term 'employee' means . . . . (2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee . . . ."

44. I.R.C. § 3306(i) (1994) reads: "For purposes of this chapter, the term "employee" has the meaning assigned to such term by section 3121(d), except that paragraph (4) and subparagraphs (B) and (C) of paragraph (3) shall not apply."

45. I.R.C. § 3401(c) (1994) reads:

For purposes of this chapter, the term "employee" includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumental-ity of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

46. Hearing, supra note 25, at 76-77.
This has traditionally been the most common method for workers to claim exemption from the employment tax regulations.\(^{47}\)

However, there is another possible exemption. Some workers can be statutorily exempted from these employment related taxes under IRC section 3508.\(^{48}\) This statute states that under Title 26, which is the Internal Revenue Code, individuals performing services as real estate agents or direct sellers shall not be treated as employees.\(^{49}\) In other words, individuals who satisfy IRC section 3508 can statutorily qualify as independent contractors and can be exempt from employment related taxes under the IRC.\(^{50}\)

The impact the employee/independent contractor classification can have on the legal obligations of the employer and the worker, as well as on other parts of the Internal Revenue Code,\(^{51}\) gives the IRS reason to focus particularly close attention on any independent contractor classification. In other words, there is a strong possibility of an IRS audit regarding the independent contractor classification.

IV. THE IRS AUDIT

A. The IRS Audit and the Ramifications of Reclassification

In conducting audits of employers, the IRS looks for trends within certain market segments and subsequently targets these segments for


\(^{48}\) For the wording of I.R.C. § 3508, see supra note 13.


\(^{50}\) As will be discussed infra parts V & VII, mortgage brokers are now arguing that their loan officers qualify under the definition of real estate agents and satisfy the three elements of § 3508. Therefore, mortgage brokers claim they should be statutorily exempt from these employment related taxes. The IRS has not addressed this argument in Revenue Rulings or in Private Letter Rulings. If mortgage brokers and loan officers can qualify under this statutory exemption, the loan officers would qualify as independent contractors regardless of the analysis and results of the common law test. Therefore, even though the IRS has made rulings in the past regarding the status of loan officers under the common law analysis, holding them to be employees, loan officers can qualify as independent contractors if the IRS agrees with their statutory exemption argument.

\(^{51}\) Hearing, supra note 25, at 77-78.
audits. The IRS claims this approach allows the IRS to be more efficient in what they do, brings more standardization to an industry, and provides more understanding to the rules. An example of a trend that has been targeted by the IRS is the classification of loan officers as independent contractors in the mortgage brokerage industry.

During an audit, the IRS will evaluate whether a firm has properly classified a worker as an employee or an independent contractor. If the firm has classified the worker as an independent contractor, the IRS will review the classification by applying the common law test for classification or applying the elements of the pertinent statute. If, during the audit, the IRS determines that the firm has misclassified the employee as an independent contractor, the obligations attendant to treatment as an employee are imposed on the employer. The IRS may assess the firm three years of back withholding for each “employee” misclassified regardless of whether or not that “employee” has paid the self-employment and income taxes pertaining to the income. Also, the IRS can assess the firm an effective penalty of 1.5% of the wages that should have been withheld and 20% of the unpaid social security taxes for each misclassified employee for the past three years. The IRS prevents employers from offsetting against this amount taxes already paid by the independent contractor. Finally, if the employer fails to file the correct forms (informational returns, Form 1099), the employer will pay even a steeper fine on misclassified employees. These statutory penalties under section 3509 apply excessively burdensome penalties on small firms. Still other penalties may also follow.

53. Id. at C3.
54. Id. This is discussed in greater detail, infra part V.
55. For an application of these tests to loan officers working for California mortgage brokers, see infra parts VI & VII.
56. Hearing, supra note 25, at 77.
57. Id.; see also I.R.C. §§ 3509, 6501 (1994).
58. Hearing, supra note 25, at 77. “I.R.C. section 3509 has no effect on an ‘employer’s’ own liability for federal unemployment insurance taxes or the ‘employer’ portion of FICA.” Id. Also, as a trade-off, “employers” are prevented from offsetting the amount of taxes already paid by the independent contractor. Id.
59. Id.
60. Id. In such cases, they must pay a penalty of three percent of the wages that would have been withheld and 40% of the unpaid FICA taxes for the past six years. Id.
61. Id. at 78.
62. Id. The employer may be liable for the failure to file employment-related tax returns. I.R.C. § 6651(a)(1) (1994). The penalty is 5% of the amount required to be shown as tax on the “employer’s” Forms 940 and 941 for failing to file within a month of the due date, with 5% added for each month or part of a month, up to a maximum of 25%, that the filing is delayed. A separate, tiered penalty will apply for the failure
some of which are not dischargeable in bankruptcy.\textsuperscript{63}

As described above, the improper classification of a worker as an independent contractor rather than as an employee can have serious financial effects. This can be the case even when the employer, in good faith, believed the worker to be an independent contractor.\textsuperscript{64} Some believe these consequences are harsh. However, the IRS does not appear sympathetic, perhaps because of what the IRS perceives as an increase in the abuse of the independent contractor classification.

\section*{B. The Motivation for the Audit: Perceived Problems with the Use of the Independent Contractor Classification}

The IRS and others believe that there has been an increase in the use and abuse of the independent contractor classification. The recent recession and corporate layoffs have sent many individuals into business for themselves as independent contractors.\textsuperscript{65} If these individuals satisfy the test for independent contractor classification, this increase in use is not of great concern. However, many businesses are using independent contractors to cut labor costs.\textsuperscript{66} It is this use of the independent contractor classification with which the IRS is concerned.

\begin{itemize}
\item to make timely deposits of withheld income and employment taxes as is required of the "employer." The "employer" may also be liable for a negligence penalty. I.R.C. § 6653(a) (1994). Finally, if the "employer" is thought to have intentionally misclassified the employee, a 100\% penalty on the amount of the taxes owed is payable. I.R.C. § 6672 (1994). Section 6672 applies to responsible officers of the corporation as well. This penalty is not dischargeable in bankruptcy. Hearing, supra note 25, at 78.
\item In the event informational returns are not filed, the firm may be liable to pay $50 for each failure to file an information return. Also, in the event the firm fails to file correct information returns, the firms is responsible for a maximum amount of $50 per return. Id.
\item Finally, an "employers" pension or health plan can be jeopardized by the inclusion of the workers as employees. The smallest employers, who are disproportionately affected by the top heavy rules and the nondiscrimination tests, are the most likely affected. And "employers" may be surprised to discover that they are subjected to a host of other, nontax requirements, such as those under the Fair Labor Standards Act, the Minimum Wage Act, or state workers compensation laws. Id.
\item Hearing, supra note 25, at 78. Additionally, if the debts are not dischargeable in the bankruptcy of the corporation, there is a serious chance that large personal debt obligations may result. These debts may lead some into personal bankruptcy. Id. at 79.
\item Id. at 77-78.
\item Michael J. Kinkelaar et al., Will the Real Independent Contractor Please Stand Up?, SAN DIEGO BUS. J., July 18, 1994, at A1.
\item Id.
\end{itemize}
The IRS believes the use of independent contractors is an "illegitimate way for employers to cut payroll taxes."67 Through the use of independent contractors, employers relieve themselves of some Social Security, unemployment, and other payroll taxes, thereby cutting the cost of labor.68 This is supposed to shift the responsibility to the employee to pay the taxes, but enforcement against the employee is difficult—at least more difficult than collecting the taxes from the employer.69 Therefore, the government prefers to collect taxes from the employer where possible.70

The IRS is concerned that misclassification results in (or is sometimes the result of) fewer checks on independent contractors than on employees.71 Because the income third parties pay to independent contractors is not subject to withholding, independent contractors have a statistically greater opportunity to overstate deductions, understate income, or fail to file entirely.72 "The IRS contends that because independent contractors are less compliant than employees, compliance can increase by treating these workers as employees."73

The IRS has contended for several years that improper classification of independent contractors results in the loss of large amounts of tax revenues.74 The IRS's data show that in 1984 at least $1.6 billion in tax revenues were lost because employers misclassified workers as independent contractors.75 As a result, the IRS has decided to audit many companies who qualify people as independent contractors.76

The IRS's crackdown on the abuse of the independent contractor classification is understandable and commendable. However, if the attempt to reclassify independent contractors as employees is because enforcement against independent contractors is more difficult, then such reclassification should not be tolerated. Legitimate independent contractors and their service recipients should not be forced to bear the

67. Kinsman, supra note 52, at C3.
68. Id.
69. Hearing, supra note 25, at 76-77, 81-83.
70. Id. at 81-83.
71. Id. at 83.
72. Id.
73. Id.
74. Kinsman, supra note 52, at C3; see also Hearing, supra note 25, at 83-84.
75. Hearing, supra note 25, at 83-84.
76. Kinsman, supra note 52, at C3. Judith Goldman, spokeswoman for the IRS in Laguna Niguel, California, says, "[W]e want to find out if those people are really independent contractors or whether they are employees. It is my understanding that they have been calling these people independent contractors for quite a while. That's fine, if they are truly independent contractors. That's what we're looking at." Id. Her comments are in regard to one targeted group for audits: mortgage brokers and their loan officers.
burden of the IRS’s ineffective enforcement efforts. Tax compliance can be increased by effectively enforcing the existing rules. No stepped up reclassification efforts may be needed.

Under current IRS rules, the recipient of independent contractor services is required to provide an informational return (Form 1099) describing the services received. 77 It is the IRS’s job to match these returns with the independent contractor’s individual income tax return. "IRS Taxpayer Compliance Measurement Program (TCMP) data indicate that most of the tax gap attributable to independent contractors status stems from the failure of the service-recipient to file requisite Forms 1099." 78 "According to a 1977 TCMP study by the IRS, when Forms 1099 are filed, there was a 97% compliance rate on the payment of taxes on income paid to the independent contractor, as opposed to an 83% compliance rate when the forms were not filed." 79 Therefore, this study shows that the loss of income associated with independent contractors may not be the result of misclassification, but rather the poor enforcement by the IRS of Form 1099 compliance.

The IRS might consider improving its enforcement efforts to recover some of these allegedly lost tax dollars, rather than targeting market segments for audits and potential reclassifications. As stated above, reclassification and punishment of abusive employers are commendable. However, the reclassification and punishment of employers who in good faith classified their employees as independent contractors should be avoided.

Further, in evaluating a worker’s classification as an independent contractor, neither the IRS nor anyone else should assume that the worker and employer are abusers of the classification. 80 It is important to evaluate the arguments on behalf of the independent contractor with an objective, impartial view. One should approach the case of the

77. Hearing, supra note 25, at 86.
78. Id.
79. Id.
80. The IRS claims to take this objective approach. See, e.g., Kinsman supra note 52, at C3. However, some mortgage brokers do not believe the approach to audits is objective. A Pacific Beach broker said, "[w]hat bothered me most was the way this IRS auditor kept saying 'I'm going to find... I'm going to stop... I'm going to force you'... It sounded more like a career case to me—a case where he planned to make a name for himself." Kinsman, supra note 52, at C3. These comments were made after an IRS agent visited a meeting of the San Diego Association of Mortgage Brokers.
California mortgage brokers and their loan officers with this objective perspective.

V. THE CASE OF CALIFORNIA MORTGAGE BROKERS AND THEIR LOAN OFFICERS

The IRS has identified mortgage brokers as one segment to target for audits.\(^81\) IRS audits have already targeted 800 mortgage brokers in San Diego County for their treatment of loan officers as independent contractors.\(^82\) San Diego appears to be at the center of this targeted approach to audits of mortgage brokers.

It is extremely important that the reader understand the meaning of the term “mortgage broker.” A “mortgage broker” is a person or firm who functions as an intermediary between a borrower and a lender in securing a loan.\(^83\) For securing a loan, the “mortgage broker” receives a commission on the loan.\(^84\) This terminology is rather confusing because the term “mortgage broker” can refer to a company, otherwise known as a brokerage firm, or to an individual. For example, John Doe is an individual and can properly be referred to as a mortgage broker.\(^85\) He qualifies as a mortgage broker in California because he is a licensed real estate broker that solicits borrowers or lenders in connection with loans secured by liens on real property.\(^86\) John Doe is also the owner

\(^{81}\) Kinsman, supra note 52, at C3. One reason mortgage brokers may have been targeted is due to the large amounts of money that have been involved in this industry in the past few years. Due to the prevailing low level of interest rates during the past three years, mortgage brokers have been successful in securing a large volume of loan refinancing business. The IRS has become aware of these activities and the potential income associated with a reclassification of loan officers as employees.

\(^{82}\) Id. at C1.

\(^{83}\) BLACK’S LAW DICTIONARY 1011 (6th ed. 1990).

\(^{84}\) See Kinsman, supra note 52, at C3.

\(^{85}\) The case of John Doe is a hypothetical example based in part on information found in the Kinsman article. Mr. Doe and his company J.M. Doe Co. are used to demonstrate the terminology and relationships of mortgage brokers, brokerages and loan officers.

\(^{86}\) See CAL. BUS. & PROF. CODE § 10131 (West 1987). The California Business and Professions Code does not provide specific rules for mortgage brokers and loan officers. However, CAL. BUS. & PROF. CODE §§ 10016, 10130, 10131, 10132 (West 1987) provide rules for real estate brokers and real estate salespersons. Although these provisions provide rules for real estate brokers and real estate salespersons, they also provide guidance for mortgage brokers and loan officers. Specifically, in § 10131, one of the acts of a real estate broker is the solicitation of borrowers and lenders in connection with loans secured directly or collaterally by liens on real property. Although this is one function of a real estate broker, it is the primary function of a mortgage broker. Thus, in a way, a mortgage broker is a real estate broker with a more limited focus. Mortgage brokers are subject to all the regulations that real estate brokers are subject to with the difference between the two being that the mortgage broker focuses
of a ten worker company called J.M. Doe Co. This company can also properly be referred to as a mortgage broker but is more commonly referred to as a mortgage brokerage or mortgage brokerage firm.

It is also important that the reader understand the function of “loan officers” and their relationship to mortgage brokers. It was mentioned above that J.M. Doe Co. is a ten worker brokerage owned by a mortgage broker by the name of John Doe. John has contracted with ten workers which he refers to as “loan officers.” Loan officers are individuals who process loan applications in property transactions. Loan officers typically meet with loan applicants, helping them fill out paperwork and assemble information for obtaining loans. The loan officers are compensated by receiving a portion of the commission on the loan received by the mortgage broker. Mortgage brokers, such as John, can and often do contract with California licensed real estate salespeople to work with them as loan officers. By contracting with loan officers, mortgage brokers can multiply their efforts in soliciting borrowers or lenders. In California, loan officers must be licensed real estate salespersons and must be registered with the mortgage broker with whom they work. Therefore, in the example of J.M. Doe Co., a loan officer that works with John would be a licensed real estate salesperson registered under John’s real estate broker’s license. This enables the loan officer to engage in most of the activities of a mortgage broker but the loan officer must do these acts in the name of the licensed real estate broker, not in their own name. In the example above, the worker could solicit borrowers or lenders in connection with loans secured by
liens on real property but the worker would do so in the name of J.M. Doe Co.\textsuperscript{92}

The relationship between mortgage brokers and loan officers described above is similar to the relationship between California licensed real estate brokers and licensed real estate salespersons. A licensed real estate broker is referred to as a broker. If the broker owns a company, the company is most commonly referred to as a real estate brokerage. The broker hires or contracts with workers called real estate agents or salespersons. A licensed real estate salesperson can engage in nearly all the activities of a real estate broker, but must engage in these activities in the name of the broker under whom they are registered.\textsuperscript{93} A real estate broker negotiates the sale, exchange, lease, etc. of property for a commission.\textsuperscript{94} The real estate agent receives a portion of the commission received by the real estate broker. Moreover, there are even licensing similarities. A mortgage broker holds a real estate broker’s license and the loan officer is a licensed real estate salesman.\textsuperscript{95}

These similarities are important because a real estate broker and a real estate salesman clearly qualify as statutory independent contractors for federal employment tax purposes.\textsuperscript{96} However, the key issue for this Comment is whether a loan officer working with a California mortgage broker enjoys the same statutory qualification as an independent contractor for federal employment tax purposes as do real estate agents working with real estate brokers.

As mentioned, mortgage brokers and loan officers operate in a similar, if not identical, fashion to real estate brokers and salespeople. Thus, many loan officers have assumed that they too are operating as statutory nonemployees.\textsuperscript{97} As a result, mortgage brokers in San Diego, and throughout the state, have traditionally treated and classified their loan officers as independent contractors.\textsuperscript{98} It is estimated that more than

\textsuperscript{92} See \textit{CAL. BUS. \& PROF. CODE} §§ 10132, 10131, 10137, 10160 (West 1987). Some people are qualified to be issued a broker’s license but operate as salespersons in the employ of another. Some states call these persons “broker-salesmen.” \textit{E.g.}, \textit{FLA. STAT. ANN.} § 475.01 (West 1991). This Comment will adhere to standard terminology and less complex relations to avoid confusing the reader.

\textsuperscript{93} See \textit{CAL. BUS. \& PROF. CODE} §§ 10016, 10131, 10132, 10137, 10160 (West 1987).

\textsuperscript{94} For a list of activities of a real estate broker, see \textit{CAL. BUS. \& PROF. CODE} § 10131 (West 1987).

\textsuperscript{95} Required under \textit{CAL. BUS. \& PROF. CODE} §§ 10131, 10132 (mandating this requirement); \textit{see also Asucion}, 152 Cal. App. 3d 422, 199 Cal. Rptr. 514; \textit{Grabau}, 151 B.R. 227; \textit{Audit Letter}, \textit{supra} note 90.


\textsuperscript{97} Kinsman, \textit{supra} note 52, at C3.

\textsuperscript{98} \textit{Id.}
eighty percent of the state’s mortgage brokers use independent contractors rather than employees for loan processing. 99

However, trouble began brewing in San Diego in 1993 after a couple of mortgage brokers were audited by the IRS. Because small businesses in other industries had already been audited, it seemed just a part of common review practice. 100 All that changed in early 1994 at a meeting of the San Diego Association of Mortgage Brokers, when an IRS auditor confirmed that mortgage brokers were a target of an IRS movement to curb improper use of independent contractor classifications. 101

The greatest problem with the IRS inquiry is that the IRS is aggressively applying its common law-derived policy that loan officers are employees and not independent contractors. 102 This enforcement has resulted in large assessments against mortgage brokers that threaten to put many out of business. 103

If the possibility of going out of business is not bad enough, the operators of the brokerage firms may suffer personal financial hardship because portions of the tax assessments may not be dischargeable if the brokerage firms are forced into bankruptcy. 104 Therefore, the financial hardship may fall personally on many individuals.

The IRS has not issued any Revenue Ruling regarding this section 3508 statutory argument nor has the IRS issued a Private Letter Ruling. 105 Further, no case addressing this statutory argument has reached the courts. 106 Thus, this statutory classification issue is undecided, whereas the implications of such a decision are great. 107

99. Id.
100. Id.
101. Id. There was some concern with the manner the IRS agent addressed the mortgage brokers. See supra note 80, regarding IRS agent’s comments during the meeting.
102. Kinsman, supra note 52, at C3.
103. Id. at C1. One 10-worker mortgage brokerage owes $238,000 in back taxes and penalties from 1990. He recently converted his work force from contractors to employees, but the IRS says he should have been doing that all along. Id.
104. Hearing, supra note 25, at 78; see discussion supra part IV.
105. A party must raise this argument and request a ruling from the IRS before the IRS will consider issuing such a ruling. See supra note 14.
106. Kinsman, supra note 52, at C3. This may be because no party has raised the statutory argument with the IRS in a case that has proceeded to the courts.
107. At this point, the reader should have an understanding of the size and importance of the independent contractor segment and the legal framework for the
This statutory argument is analyzed in detail below. However, the author will first analyze the common law approach to the employee/independent contractor classification. This analysis will include an explanation of the IRS's holdings in a Revenue Ruling and a Private Letter Ruling and an explanation of the relevance of these rulings. A detailed analysis of the statutory exemption argument will follow the common law approach. Following the analysis of the common law approach and the statutory approach, the author will recommend the IRS issue a Revenue Ruling or Private Letter Ruling addressing this statutory argument.

VI. THE COMMON LAW APPROACH TO THE CLASSIFICATION

As outlined above, the federal employment tax regulations adopt the federal common law test to determine whether a worker qualifies as an employee or an independent contractor.\(^{108}\) Although both federal and state common law address the issue of whether a worker should be considered an employee or an independent contractor, the analysis will focus on the federal common law because this Comment is concerned with federal employment tax regulations.\(^{109}\)

A. Federal Common Law

Federal common law rules are applied to determine whether particular workers are treated as employees or as independent contractors (self-employed persons) for purposes of federal employment taxes.\(^{110}\)

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\(^{108}\) See discussion supra part III.


\(^{110}\) The common law factors are listed in the following Internal Revenue Service document: Exhibit 4640-1, 3 INTERNAL REVENUE MANUAL, AUDIT 8465; see also I.R.C. § 3508, 12 U.S. Tax Rep. (RIA) ¶ 35,081 (Sept. 3, 1982).
Under the federal common law test, an employer-employee relationship generally "exists" when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. In other words, the employer-employee relationship requires that the employee be subject to the will and control of the employer not only as to what shall be done but how it shall be done. Thus, the most important factor under the federal common law is the degree of control, or right of control, which the employer has over the manner in which the worker is to perform services for the employer.

1. The Factors

There are twenty factors to apply under the common law test to determine if a worker is an employee or an independent contractor. The test may appear rather nebulous. A particular factor may not apply in a given case. If a factor does apply, its importance varies depending on the occupation and the relevant facts and circumstances. Further, the IRS retains the power to determine the weight given to each factor. Thus, one factor may be enough to tip the scales in classifying the worker as an employee.

The twenty common law factors generally considered in determining whether an employer-employee relationship exists are directed at the following questions. The answer in regard to a common law employee follows each question. The twenty common law factors are:

1. Exhibit 4640-1, 3 INTERNAL REVENUE MANUAL, AUDIT 8465.
2. It does not matter whether this control is exercised or not.
3. Exhibit 4640-1, 3 INTERNAL REVENUE MANUAL, AUDIT 8465.
6. The difficulties in meeting the common law test illustrate the benefit of qualifying as a statutory nonemployee under I.R.C. § 3508 (1994). Regardless of the common law test outcome, if a worker satisfies § 3508, the worker is an independent contractor.
7. As mentioned supra note 110, the common law factors are set forth in the following Internal Revenue Service documents: Exhibit 4640-1, 3 INTERNAL REVENUE MANUAL, AUDIT 8465; see also I.R.C. § 3508, 12 U.S. Tax Rep. (RIA) ¶ 35,081 (Sept. 3, 1982).
1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?
   
   Employees must comply with the employer's instructions about the work.

2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?
   
   Employees receive training from or at the direction of the employer.

3. Are the services performed by the individual integrated into the business's operations?
   
   Employees provide services that are integrated into the business.

4. Must the services be rendered personally?
   
   Employees provide services that must be rendered personally.

5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?
   
   Employees hire, supervise, and pay assistants for the employer.

6. Is the relationship between the individual and the person for whom he or she performs services under contract?
   
   Employees have a continuing working relationship with the employer.

7. Who sets the hours of work?
   
   Employees must follow set hours of work.

8. Is the individual required to devote full-time to the person for whom he or she performs services?
   
   Employees work full-time for an employer.

9. Does the individual perform work on another's business premises?
   
   Employees do their work on the employer's premises.

10. Who directs the order or sequence in which the work must be done?
    
    Employees must do their work in a sequence set by the employer.

11. Are regular oral or written reports required?
    
    Employees must submit regular reports to the employer.

12. What is the method of payment—hourly, weekly, commission, or by the job?
    
    Employees must receive payments of regular amounts at set intervals.

13. Are business or traveling expenses reimbursed?
    
    Employees receive payments for business and/or traveling expenses.

14. Who furnishes tools and materials necessary for the provision of services?
    
    Employees rely on the employer to furnish tools and materials.
15. Does the individual performing services have a significant investment in facilities used to perform services?
   *Employees lack a major investment in facilities used to perform the services.*

16. Can the individual providing services realize both a profit or a loss?
   *Employees cannot make a profit or suffer a loss from their services.*

17. Can the individual providing services work for a number of firms at the same time?
   *Employees work for one employer at a time.*

18. Does the individual make his or her services available to the general public?
   *Employees do not offer their services to the general public.*

19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?
   *Employees can be fired by the employer.*

20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?
   *Employees may quit work at any time without incurring liability.*

As mentioned above, the IRS retains the power to determine the weight to give to each of the twenty factors. However, one study investigated the general weighting schemes of tax advisers for the twenty factors independent of specific facts and circumstances. The study concluded that five of the twenty factors accounted for approximately fifty percent of the overall importance to the classification decision. These five factors, in order of importance, are: 1) whether the worker can realize a profit or a loss; 2) whether the worker has made a significant investment; 3) whether the worker is required to work full-time; 4) whether the worker can make his services available to the general public; and 5) whether the worker may work for more than one firm. These factors correspond, respectively, to factors 16, 15, 8, 18, and 17.

119. Id.
120. Id.
2. Application of the Factors

To determine whether a worker is an employee or whether the worker qualifies as an independent contractor, the above questions must be answered in light of the particular facts and circumstances of the worker in question. In at least two specific rulings, the IRS applied these factors to loan officers working with mortgage brokers and concluded that the loan officers were employees. 121

One ruling came in 1957 in the form of a Revenue Ruling. 122 An IRS Revenue Ruling is an interpretation of the Code with respect to a particular set of facts. 123 Revenue Rulings are "directly responsive to, and limited by, the stated factual basis of the underlying letter ruling or technical advice request, much in the manner of a judicial decision." 124 They are published in the Internal Revenue Bulletin for the information and guidance of taxpayers, IRS personnel, and others concerned. 125

Revenue Ruling 57-402 concerned workers engaged by a loan brokerage firm to solicit loan business from realtors and builders. The workers inspected and appraised properties for loan purposes and prepared loan applications that they presented to the firm for approval. They also assisted in the closing of loans. The workers used the firm's office facilities, but furnished their own automobiles, cameras, and tape lines. They were remunerated solely by commissions on completed loans. The workers received instructions from the firm as well as leads to prospective customers, which they were required to follow up. They operated under the firm's business name as well as their own, but did not perform services for others or advertise their availability to do so. The firm carried workmen's compensation insurance on them and paid for their licenses. They performed their services under oral agreement and could have been terminated at any time. 126 The Revenue Ruling concluded that the workers were employees of the firm for federal employment tax purposes. 127

In applying the common law factors to the case above, it appears that at least half of the twenty factors favored the conclusion that the workers

124. Id.
125. Id. at 764.
127. Id.
were employees,\textsuperscript{128} including two of the five most important factors in the minds of tax advisors.\textsuperscript{129} Therefore, the IRS's decision seemed reasonable.

The second ruling came in the form of an IRS Private Letter Ruling.\textsuperscript{130} Like Revenue Rulings, a Private Letter Ruling is an interpretation of the Code with respect to a particular set of facts.\textsuperscript{131} However, a Private Letter Ruling is not generally published, but instead is issued to a specific taxpayer and is generally issued in respect to transactions that have not been consummated.\textsuperscript{132} A Private Letter Ruling is only binding on the taxpayer to which the letter is addressed.\textsuperscript{133} A Private Letter Ruling cannot be used or cited as precedent. However, parties still use them to support their arguments in cases of first impression. Private Letter Ruling 89-40-038 concerned workers engaged by a mortgage brokerage that brokered primarily residential mortgages to various lenders. The workers solicited loans, assisted in the processing of loans, and contacted realtors in order to solicit additional business for the firm. Although the details are rather complex, the specifics of the relationship included the following: the workers were not required to provide any materials, equipment, or supplies; the firm provided all necessary materials. The workers performed all services at the firm's location. Further, the company paid the workers a commission, but the workers were able to draw against future earnings. The workers performed services on a full-time basis and did not perform similar services for others. The firm had priority on the workers' time and the workers were unsure whether they were prohibited from competing with the firm. The workers had the right to terminate their services at any time without incurring liability. The workers did not have an investment in the enterprise and did not assume the risk of realizing a profit or suffering a loss. Finally, the workers were required to follow firm instructions regarding the loans.\textsuperscript{134} In the ruling, the IRS concluded the workers were employees.\textsuperscript{135}

\textsuperscript{128.} See factors 1, 2, 3, 6, 7, 9, 17, 18, 19, and 20 discussed supra in part VI.A.1.
\textsuperscript{129.} See factors 17 and 18 discussed supra in part VI.A.1.
\textsuperscript{130.} Priv. Ltr. Rul. 89-40-038 (July 10, 1989).
\textsuperscript{131.} Rogovin, supra note 123, at 766.
\textsuperscript{132.} Id. at 764.
\textsuperscript{133.} Id. at 769.
\textsuperscript{134.} Priv. Ltr. Rul. 89-40-038 (July 10, 1989).
\textsuperscript{135.} Id.
In applying the common law factors to the case above, it appears that over half of the twenty factors favored the conclusion that the workers were employees, including the five most important factors in the minds of tax advisors. Therefore, it again appeared the IRS's decision was rather simple and reasonable.

Although these rulings are fact specific, it is rather clear under the common law test that the workers qualified as common law employees. Therefore, these rulings provide little guidance to loan officers who are more careful in structuring their relationships with their brokerage firms in hopes of qualifying as independent contractors.

In the hopes of providing greater guidance to mortgage brokers and their loan officers regarding the common law test, the test should be applied to mortgage brokers who are currently being audited. However, it is virtually impossible to consider the facts and circumstances of each and every loan officer working with a mortgage broker. Therefore, for purposes of analysis, the author will assume that the mortgage brokerage followed the legal advice of tax professionals and reviewed with legal counsel, in advance, all its contracts and the structure of the business relationships with its loan officers. The author will also assume the brokerage followed the advice of professionals and structured the contracts and business relationships in the most strategic manner to qualify its loan officers for independent contractor classification.

Under these assumptions the author will apply the common law factors to the circumstances of loan officers working with mortgage brokers. In analyzing each of the twenty factors, the answer for an employee classification is presented. Subsequently, reasoning is set forth to determine whether mortgage brokers and loan officers could avoid treatment as common law employees if their relationship was properly structured.

1. **Employees must comply with employer's instructions about the work.**

All requirements by a mortgage brokerage for loan officers could be set forth in the contracts with loan officers. In this manner, loan officers could avoid complying with any further instructions regarding their work from their employers.

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136. See factors 1, 2, 3, 7, 8, 9, 14, 15, 16, 17, 18, and 20 discussed supra in part VI.A.1.

137. See factors 8, 15, 16, 17, and 18 discussed supra in part VI.A.1.

138. Kinkelaar et al., supra note 65. Michael Kinkelaar, Esq., is a partner with Procopio, Cory, Hargreaves and Savitch specializing in the areas of business and tax law.

2. **Employees receive training from or at the direction of the employer.** If a brokerage set forth standards and requirements for its loan officers in writing, any form of training could be avoided. New loan officers could simply be given the guidelines in writing as part of their contracts and be expected to follow them. It would be up to the new loan officers to train themselves by familiarizing themselves with the guidelines.

3. **Employees provide services that are integrated into the business.** The services of loan officers are the business of a brokerage. A brokerage makes its money off of commissions earned from securing loans originated and processed by its loan officers. Thus, this may be a problem for mortgage brokers in that the IRS will view the loan officers as employees.

The problem with this factor may be the reason real estate brokers, real estate agents, and direct sellers were able to secure the passage of IRC section 3508, which explicitly qualifies them for treatment as independent contractors regardless of the common law analysis. 142

4. **Employees provide services that must be rendered personally.** Loan officers do not have to render all the loan processing services themselves. Loan officers could hire their own employees to process the loans enabling the loan officers to spend more time soliciting borrowers or lenders. The loan officer could not, however, delegate the job of soliciting loans unless the person conducting the work was also a licensed real estate salesperson registered under the mortgage broker. The brokerage is only concerned with securing loans for applicants and earning a commission for doing so. If the loan officers find a legal and efficient means of securing applicants they are satisfied. Therefore, aside from the solicitation of borrowers and lenders, there does not seem to be a requirement that the loan officers personally do the work in the contract. The solicitation element may be a problem under the IRS's analysis.

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140. *Id.*
141. *Id.*
142. This statute, I.R.C. § 3508, is discussed in great detail in part VII, *infra.*
5. *Employees hire, supervise, and pay assistants for the employer.*

A brokerage could be structured so that loan officers do not spend much time in the office and do not interact with office support staff. Brokerages may actually prefer this structure because loan officers would be forced to spend more time in the field and spend more time interacting with potential borrowers instead of pushing paper in the office.

6. *Employees have a continuing working relationship with the employer.*

Brokerages could offer loan officers contracts for a certain period of time or a certain volume of loans. If the loan officers are successful at meeting these goals, contracts could be renewed. There is no reason they would have to have an indefinite working relationship.

This type of set up would be beneficial for loan officers in that if they were successful with a given contract, they would have the choice to renew with the same brokerage or perhaps solicit employment offers from other brokerages who may pay a higher commission to the loan officer. The loan officer would have to re-register under the new broker if the loan officer chooses to work for another broker at the end of the contract period.

7. *Employees must follow set hours of work.*

Loan officers can set their own hours. The important thing is that they close loan deals because even if they work long hours, they do not receive compensation unless they perform.

8. *Employees work full-time for an employer.*

Loan officers do not have to work full-time. As mentioned above in Section One, many loan officers are mothers who work part-time, moonlighters looking for extra income, and others looking for full-time employment.

9. *Employees do their work on the employer's premises.*

Loan officers spend most of their time on the phone with clients and lenders or in meetings with clients and lenders. These activities do not need to be done on the brokerage premises. The activities of loan

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144. *Id.*
145. *Id.*
146. *See supra* note 90 and accompanying text (regarding the requirement to register under a broker).
147. *Common Law Factors, supra* note 139.
148. *Id.*
149. *Id.*
150. Loan processors are usually located on the premises of the brokerage and process the applications generated by loan officers and mortgage brokers. *These*
officers can be done at a separate office rented by the loan officer, from a car with a cellular phone, from the home of the loan officer or loan applicant, from the office of the lender, or from the location of the desired home to be financed.\textsuperscript{151}

10. \textit{Employees must do their work in a sequence set by the employer.}\textsuperscript{152}

As mentioned above, the key concern for all involved is that the applicant gets a loan from a lender and the brokerage earns a commission. General guidelines may need to be followed in order to properly process an application, but this can be set forth in a contract. No particular sequence needs to be followed.

11. \textit{Employees must submit regular reports to the employer.}\textsuperscript{153}

No reports are required by a brokerage from a loan officer. The only concern is the number of loans the loan officer has secured that will earn a commission for the brokerage.

12. \textit{Employees must receive payments of regular amounts at set intervals.}\textsuperscript{154}

Loan officers’ remuneration is based entirely on performance. Their pay may fluctuate greatly depending on how many loans they secure. This may result in no pay for long periods of time. No salary is paid to these individuals.

13. \textit{Employees receive payments for business and/or traveling expenses.}\textsuperscript{155}

Loan officers do not receive reimbursements for these activities. If travel of any kind is required, the loan officer would be forced to cover the expense with the knowledge that the expense could result in a net loss for the loan officer if no loan is secured.

14. \textit{Employees rely on the employer to furnish tools and materials.}\textsuperscript{156}

processors are usually treated as employees. Kinsman, \textit{supra} note 52, at C3.

\begin{itemize}
\item \textsuperscript{151} Some mortgage brokers set up tables at new housing developments to qualify potential purchasers for financing.
\item \textsuperscript{152} Common Law Factors, \textit{supra} note 139.
\item \textsuperscript{153} \textit{Id.}
\item \textsuperscript{154} \textit{Id.}
\item \textsuperscript{155} \textit{Id.}
\item \textsuperscript{156} \textit{Id.}
\end{itemize}
The key tools for a loan officer are a telephone, a calculator, and perhaps a computer. None of these would be required to be supplied by the brokerage. A loan officer could furnish her own tools.

15. Employees lack a major investment in facilities used to perform the services.\textsuperscript{157}

Loan officers may decide to invest in an office of their own. Others may find they spend the majority of their time in their car and on business calls and decide investing in a facility is unwise. Also, like many small business owners, they may decide to work out of their home. Therefore, investing in facilities is a business decision left to the loan officer. This factor should not pose a problem for independent contractor classification.

16. Employees cannot make a profit or suffer a loss from their services.\textsuperscript{158}

As mentioned above, a loan officer could contract with a brokerage for a number of successful loans, for a volume of dollars secured in loans, for a period of time, or other structure. Depending on the contract, a loan officer would have to evaluate her own investment of time, travel, telephone expenses, and supplies to determine the profitability of the contract. If a loan officer invests more money and time than the amount received in the form of a commission, the loan officer would suffer a loss. Under the same reasoning, the officer may also enjoy a profit. This factor should not pose a problem for independent contractor classification.

17. Employees work for one employer at a time.\textsuperscript{159}

A brokerage may or may not require a contract of exclusivity. However, a loan officer, like a real estate salesman, is required to register under one specific broker. All work is done in the name of the broker, not in the name of the loan officer. Therefore, this issue may cause problems for loan officers. As mentioned above, this may be one reason the legislature passed section 3508 giving explicit independent contractor status to real estate salesmen and brokers.\textsuperscript{160}

18. Employees do not offer their services to the general public.\textsuperscript{161}

Loan officers offer their services to the public. Therefore, there should not be a problem with this factor. However, if as applied to the services of loan officers the IRS interprets this factor to mean whether the loan officer can work for any brokerage, then this factor could pose

\textsuperscript{157} Id.
\textsuperscript{158} Id.
\textsuperscript{159} Id.
\textsuperscript{160} I.R.C. § 3508 (1994).
\textsuperscript{161} Common Law Factors, supra note 139, at 299.
a problem for independent contractor classification. As mentioned above, the loan officer must register under a licensed real estate broker and perform the work under that broker’s name.

19. Employees can be fired by the employer.\textsuperscript{162}

If loan officers are engaged pursuant to contracts, they can not then be fired at any given time. However, it is likely that many brokerages will want to terminate loan officers if their actions are damaging to the brokerage. The brokerage must make sure they terminate the workers pursuant to a contract provision and not for other reasons.

20. Employees may quit work at any time without incurring liability.\textsuperscript{163}

It appears that a loan officer could quit at any given time. A brokerage could, however, structure the contract with the loan officer so that there would be liabilities if the worker quits.

3. Federal Common Law Conclusions

There appear to be problems (i.e., loan officers appear to be employees) with the factors dealing with the integration of services, the personal rendition of some services, the offering of services to one employer at a time rather than to the general public, and the exclusive employment of loan officers by one broker.\textsuperscript{164} Although there are only four major problems out of twenty factors, the IRS determines the weight to be given to each factor.\textsuperscript{165} Further, two of the factors (making services available to the general public and working for more than one firm) are the fourth and fifth most important factors, respectively, in a survey of professional CPA tax advisors.\textsuperscript{166} These two factors account for just over fifteen percent of the cumulative importance of the twenty factors.\textsuperscript{167} Therefore, even though there are few problems with the common law factors, the IRS may conclude that loan officers are employees for employment tax purposes.

\textsuperscript{162} Id.
\textsuperscript{163} Id.
\textsuperscript{164} See discussion of factors 3, 4, 17 and 18 discussed supra in part VI.A.1.
\textsuperscript{165} During an audit, the IRS generally assumes that all workers are employees and the burden of proof of an independent contractor relationship lies squarely on the employer. See Kinkelaar et al., supra note 65, at A2.
\textsuperscript{166} Apostolou et al., supra note 118, at 1394.
\textsuperscript{167} Id.
If the IRS concludes that loan officers are employees, then they cannot qualify for exemption from federal employment tax regulations as common law independent contractors. In order to qualify for exemption from the federal employment tax regulations, they would have to qualify for independent contractor treatment under a federal statute.

VII. THE STATUTORY EXEMPTION ARGUMENT

The statutory approach to exemption from federal employment tax regulations begins by identifying a particular statute that addresses independent contractors or particular categories of workers. For loan officers working with mortgage brokers there are two relevant statutes: section 530 of the Revenue Act of 1978 and IRC section 3508.¹⁶⁸ This Comment will focus on section 3508.¹⁶⁹

The legislative history of the independent contractor statutes is provided to explain why section 3508 is the relevant statute for loan officers working with mortgage brokers. This history is also helpful in setting forth the purpose of the statutes. Following the legislative history, the author will analyze in detail the statutory exemption argument under section 3508.

A. Legislative History of the Statutes

In the 1960s and 1970s the IRS began to accelerate its enforcement efforts against misclassification of workers as independent contractors.¹⁷⁰ Taxpayers complained, and in response to these complaints, the House and Senate Conferees in the 1976 Tax Reform Act urged the IRS not to "apply any newly stated position . . . inconsistent with a prior general audit position."¹⁷¹

"Two years later, in the wake of continuing confusion over the application of common law rules and increasingly aggressive enforcement, a task force was impaneled to examine the appropriate bases of

¹⁶⁸. For many workers the only statute will be § 530 of the Revenue Act of 1978. The elements of § 530 will be set forth below. For workers associated with direct sales or real estate activities there may be an additional statute under which they can qualify as statutory nonemployees: IRC § 3508. See I.R.C. § 3508 (1994).

¹⁶⁹. The author has chosen to focus on § 3508 for two reasons. First, the author believes loan officers have a stronger argument for qualification under § 3508 than under § 530. Second, as will be discussed below, § 530 has two problems: 1) there appears to be an incessant push by the enforcement community to erode its protection; and 2) it is uncertain whether loan officers working with mortgage brokers qualify for its protection in the first place.


independent contractor status.” After considerable exploration of the issue and unsuccessful proposals to define a safe harbor, a temporary “solution” was found: section 530 of the Revenue Act of 1978. Section 530 was intended as a stop-gap measure to provide interim relief to certain taxpayers involved in employment tax status controversies with the IRS until Congress could find an acceptable definition of independent contractor status.

Section 530 created a much needed safe haven for classifying workers. Among other things, section 530 permitted workers to be treated as independent contractors for employment tax purposes if the firm had a “reasonable basis” for so classifying and if they filed the requisite information returns and treated their workers consistently. A “reasonable basis” can be reliance on: 1) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling issued to the taxpayer; 2) a past IRS audit of the taxpayer in which there was no assessment attributable to the employment tax treatment of individual(s) holding positions substantially similar to the individual; or 3) a long-standing, recognized practice of a significant segment of the industry in which the worker, whose status was at issue, was engaged. Workers who did not meet the safe harbor tests of section 530 still would have had their employment tax status determined under the common law rules.

In the years that followed, controversies regarding independent contractor classification continued. Again, because of the difficulty that often arises in applying the twenty common law factors, several bills introduced to both the House and Senate during 1982 set forth statutory “safe harbor” tests that, if satisfied with respect to an individual, would

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172. Id.
175. Hearing, supra note 25, at 71.
176. Id. at 72.
result in that individual being classified as an independent contractor or a statutory nonemployee. Eventually, Congress passed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) in an effort to create a more permanent solution to the independent contractor classification problem. The Conference Agreement for TEFRA did not include any safe harbor test, but instead created two categories of statutory non-employees: qualified real estate agents and direct sellers. "Congress created a shelter exclusively for 'certain direct sellers and real estate sales persons' because it 'believed that it was these workers who were most in need of an immediate solution to the problem of proper employment tax status.'

The primary reasons cited for the proposed law were that a statutory safe harbor test would reduce the number of controversies and would provide greater certainty and simplification in this area of tax law. Further, the formal requirements of the safe harbor would greatly improve tax compliance on the part of independent contractors qualifying under its provisions. Therefore, notwithstanding the common law rules, an individual is an independent contractor for services that satisfy the statutory requirements of section 530 or IRC section 3508.

B. Section 530

There are two problems with section 530. First, there appears to be an incessant push by the enforcement community to erode the protection of section 530. Second, it is uncertain whether loan officers working with mortgage brokers would qualify for protection under section

177. Id.
178. Id. at 72 n.10.
182. Id.
183. See infra part VIII.B.-F. for an analysis of both.
184. Hearing, supra note 25, at 73. For example, in 1986, large technical service firms were successful in urging Congress to enact section 1706 of the Tax Reform Act of 1986. Section 1706 repealed § 530 and the protection it provided in the case of certain technical workers. With the partial repeal of § 530, uncertainties over the classification of workers under the common law guidelines have been resurrected for some contractors. Id.
530 because it is uncertain whether the treatment of loan officers as independent contractors is a customary practice of the industry. The California Mortgage Broker Association is currently surveying approximately 10,000 mortgage brokers in California to determine the standard industry practice. Therefore, loan officers working with mortgage brokers should attempt to qualify for independent contractor status under a statute other than section 530.

C. Section 3508 and California Loan Officers

In order to qualify as statutory independent contractors and be exempt from federal employment taxes, loan officers working with mortgage brokers must satisfy the elements of IRC section 3508. As will be shown below, loan officers arguably satisfy the elements of section 3508. However, there is a question as to whether loan officers qualify under the term “real estate agents.” No federal law or case provides any guidance for the definition of activities of a real estate agent. However, some state laws, including California’s, do provide definitions of the activities of real estate agents, which include the activities of a loan officer working with a mortgage broker. Thus, using case law as support, mortgage brokers are urging the IRS to adopt this rule and enable loan officers working with mortgage brokers to qualify as statutory independent contractors for federal employment tax purposes.

Each step of this argument is analyzed in detail below. To begin, the author will set forth the elements of section 3508 and apply them to the case of mortgage brokers and their loan officers. Next, the author will discuss the meaning of the term “real estate agent.”

1. The Elements of Section 3508

Three elements of section 3508 must be met to achieve independent contractor status: 1) the individual is a licensed real estate agent; 2) substantially all remuneration for the services performed by such individual as an agent is directly related to output; and 3) their services
are performed pursuant to a written contract that provides they will not be treated as employees for federal tax purposes. 188

2. Application of the Elements of Section 3508

In analyzing the activities of a loan officer working with a California mortgage broker in light of the requirements of IRC section 3508, 189 it appears as though a California loan officer is an independent contractor. First, a California court has stated that the California Business and Professions Code section 10131 is the fundamental statute specifying activities, including loan solicitation, for which a broker’s license is required. 190 Thus, to conduct brokering activities, a mortgage broker is required to have a broker’s license and a loan officer is required to be a licensed salesperson registered under a licensed real estate broker. Also, in tax decisions, 191 the California Unemployment Insurance Appeals Board has ruled that loan officers are required to maintain a valid state real estate license and are performing the duties of a statutory real estate salesperson. 192 Therefore, in California, loan officers are required to be licensed real estate agents.

Second, all of the remuneration for loan officers is from commissions. The standard practice of the industry is that a broker receives one percentage point of the loan secured. A loan officer receives a portion of this commission. 193 The mortgage broker and loan officer receive no compensation unless they successfully secure a

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189. The pertinent portions of I.R.C. § 3508 are as follows:
(1) The term “qualified real estate agent” means any individual who is a sales person if:
   (A) such individual is a licensed real estate agent,
   (B) substantially all of the remuneration... for the services performed by such individual as a real estate agent is directly related to sales or other output (including the performance of services) rather than to the number of hours worked, and
   (C) the services performed by the individual are performed pursuant to a written contract between such individual and the person for whom the services are performed and such contract provides that the individual will not be treated as an employee with respect to such services for Federal tax purposes.
190. Stickel v. Harris, 196 Cal. App. 3d 575, 582-83, 242 Cal. Rptr. 88, 92 (1987);
192. Id.
193. Kinsman, supra note 52, at C3.

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loan for a client. Therefore, remuneration for loan officers is related to sales and output rather than to the number of hours worked.

Third, it is standard practice for the industry to have loan officers perform their services pursuant to written contracts that provide the individual will not be treated as an employee with respect to such services for federal tax purposes. Therefore, it appears that loan officers working with mortgage brokers meet the requirements of section 3508 and could qualify as independent contractors for employment tax purposes.

3. Potential Problems with the Application of Section 3508

Although it appears that a loan officer working with a California mortgage broker satisfies the three requirements of IRC section 3508, the IRS will argue that this section was intended to cover only real estate agents and the activities of real estate agents. They will argue that it was not intended to include loan officers working with mortgage brokers in the securing of loans, particularly when the brokering activities are for the refinancing of an existing loan. Therefore, the key issue is whether a loan officer working with a mortgage broker falls within the definition of a qualified real estate agent.

4. Definition of Activities of a Real Estate Agent

There are no specific federal guidelines or cases describing the activities of a real estate agent. However, many states have laws that address this issue. Most states have statutes describing the state licensing requirements for various occupations and professions. Specifically, virtually every state has licensing requirements for real

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194. The proposed regulations to I.R.C. § 3508 attempt to define the activities of a real estate agent. However, these guidelines are not persuasive. For a detailed analysis of these proposed regulations, see infra part VII.D.

195. E.g., ARIZ. REV. STAT. ANN. § 32-2101 (West 1992); CAL. BUS. & PROF. CODE §§ 10131, 10132 (West 1987); FLA. STAT. ANN. § 475.01 (West 1991); ILL. ANN. STAT. ch. 225, para. 455/12 (Smith-Hurd 1993); MINN. STAT. ANN. § 82.20 (West 1986); MO. ANN. STAT. § 339.010 (Vernon 1989).

196. E.g., ARIZ. PROF. & OCC. CODE (West 1992); CAL. BUS. & PROF. CODE (West 1987); FLA. PROF. & OCC. CODE (West 1991); MO. OCC. & PROF. CODE (Vernon 1989).
estate brokers and real estate agents.\textsuperscript{197} Within these statutes, definitions are provided describing the activities for which a real estate broker’s license or a real estate salesperson’s license is required.\textsuperscript{198} In virtually every state a real estate salesman is defined as a person employed by a licensed real estate broker to do any of the acts set forth in the definition of a real estate broker.\textsuperscript{199} The definition of a real estate broker usually includes a list of activities for which a broker’s license is required.\textsuperscript{200} Moreover, in California and Minnesota, for example, this list of activities includes the solicitation of borrowers or lenders in connection with loans secured directly or indirectly by liens on real estate.\textsuperscript{201} Therefore, these states provide specific detailed definitions for the term “real estate agent” which includes the activities of loan officers and mortgage brokers.

However, some states do not include the solicitation of borrowers or lenders in connection with loans secured directly or indirectly by liens on real estate as part of their definition of the activities of a real estate broker.\textsuperscript{202} Furthermore, at least one state specifically excludes these loan brokering activities from the activities of a real estate broker.\textsuperscript{203} Therefore, there does not appear to be a uniform definition of the activities of a real estate broker or agent.

5. Federal Adoption of the State Rule

In \textit{Roemer v. Commissioner},\textsuperscript{204} the Ninth Circuit Court of Appeals addressed the issue of what law to follow when there is no general federal common law nor controlling definitions in the tax code for a key issue in a tax case. In \textit{Roemer}, the taxpayer, Roemer, was claiming the damages he received in his defamation suit against Retail Credit were excludable from gross income as personal injury damages. The IRS argued that defamation was a nonpersonal injury and thus, the damages

\begin{itemize}
\item \textsuperscript{198} See supra note 195.
\item \textsuperscript{199} See supra note 195.
\item \textsuperscript{200} See supra note 195.
\item \textsuperscript{203} \textit{La. Prof. & Occ. Code} § 37.1431 (West 1988).
\item \textsuperscript{204} 716 F.2d 693, 697 (9th Cir. 1983).
\end{itemize}
should be included in gross income. The court had to address the issue of whether the defamation of an individual constitutes a personal injury for purposes of IRC section 104(a)(2) (personal injury damages excludable from gross income). In analyzing the issue, the court discovered there was no general federal common law of torts nor controlling definitions in the tax code addressing this issue. Therefore, the court analyzed the defamation action as it developed in California state law, the state where the taxpayer brought the action. Under California law, the defamation of an individual is a personal injury. Thus, in applying California law, the court held the compensatory damages received by Roemer in his defamation suit against Retail Credit were excludable from gross income under IRC section 104(a)(2).

In the case of loan officers working with California mortgage brokers, there is no general federal common law describing the activities of real estate agents nor are there controlling definitions in the tax code. Roemer addresses the process the IRS and courts should follow in this instance. Further, Roemer was decided by the Ninth Circuit Court of Appeals which is the court of controlling jurisdiction for the instant case of loan officers working with California mortgage brokers. Therefore, Roemer is controlling and the IRS and the courts should apply Roemer in the instant case.

According to Roemer, the IRS or the court should look to California state law addressing the activities of a real estate agent because there is no general federal common law describing the activities of real estate agents and there are no controlling definitions in the tax code. California Business and Professions Code section 10016 (C.B.P.C.) provides that "real estate salesman" refers to a person licensed as a salesman. C.B.P.C. section 10132 states that a real estate salesman is any person employed by a licensed real estate broker to do

205. Id. at 695.
206. Id. at 694.
207. Id. at 697.
208. Id.
209. Id. at 700.
210. Id.
211. CAL. BUS. & PROF. CODE § 10016 (West 1987).
212. CAL. BUS. & PROF. CODE § 10132 (West 1987).
any of the acts set forth in the pertinent sections of the C.B.P.C. 213
One of the mentioned sections of activities of a real estate salesman is
C.B.P.C. section 10131. 214 This section includes the activities of a
person who solicits borrowers or lenders in connection with loans
secured directly or indirectly by liens on real estate. 215 In applying
this definition to the case of loan officers, loan officers first solicit
potential borrowers as clients. In expectation of compensation, these
loan officers then solicit lenders and negotiate loans secured directly or
collaterally by liens on real property. 216 This is true for loans in
regard to the sale of real property or in regard to the refinancing of an
existing loan secured by real property. Therefore, under California state
law, the activities of mortgage brokers and loan officers are part of the
activities of a real estate agent. Thus, in applying Roemer and California
state law it appears that loan officers qualify as statutory independent
contractors under IRC section 3508.

In addition, there are decisions by the Ninth Circuit Court of Appeals
that suggest looking to state law, such as United States v. Grayson. 217
In Grayson, the court applied federal law, but because the events that
gave rise to the case took place in California the court looked to
California’s law addressing the issue for guidance. 218 In the case of
California mortgage brokers and loan officers, all of the financing
activities take place in California. Therefore, it appears in applying the
C.B.P.C. definitions set forth above, a loan officer working with a
California mortgage broker would be given independent contractor status under IRC section 3508.

Decisions by other federal courts support this same analysis and conclusion. Federal courts have held that state law rules may be borrowed to effectuate federal policy when the federal law is incomplete on a subject. The purposes originally behind the creation of section 3508 were to reduce the number of controversies regarding employment tax status and to improve tax compliance on the part of independent contractors. The federal policy is to treat real estate agents as independent contractors. However, no definition has been provided for a real estate agent. Therefore, because the federal law is incomplete, the courts should be allowed to look to California law and the C.B.P.C. definitions set forth above. In doing so, it appears a loan officer working with a California mortgage broker would be given independent contractor status under IRC section 3508.


The above argument and analysis regarding the adoption by the IRS of the state rule is even more persuasive in light of the fact that California law regarding employee/independent contractor status is virtually identical to the federal law. First, California has common law rules similar to the federal rules. In general, if the principal has the right to control the manner and means by which the work is performed, the worker is an employee. Even if the individual in question is determined to be a common law employee, California Unemployment Insurance Code section 650 excludes from its definition of employment any services performed as a real estate salesperson or real estate broker,
if the worker meets three requirements. These requirements are virtually identical to IRC section 3508: 1) the worker is a licensed real estate broker or salesperson; 2) the worker’s remuneration for services is related to sales or output; and 3) the worker provides services that are performed pursuant to a written contract.

As set forth above, a California court has stated that California Business and Professions Code section 10131 is the fundamental statute specifying activities—including loan solicitation—for which a broker’s license is required. Also, in tax decisions, the California Unemployment Insurance Appeals Board has ruled that loan officers are required to maintain a valid state real estate license and perform the duties of a statutory real estate salesperson. Further, remuneration is related to the securing of loans and the services are performed pursuant to a contract setting forth the desired tax treatment. Therefore, in light of the relevant sections of the C.B.P.C. and C.U.I.C. section 650, in cases where loan officers are soliciting borrowers, lenders, or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity and the loan officer meets all of the above requirements in C.U.I.C. section 650, the loan officer should be considered an independent contractor. The California

224. See note 225, infra, for the text of § 650.

225. CAL. UNEMP. INS. CODE § 650 provides:

Employment does not include services performed as a real estate, mineral, oil and gas, or cemetery broker or as a real estate, cemetery or direct salesperson by an individual if all of the following conditions are met:

a) The individual is licensed under the provisions of Chapter 19 (commencing with Section 9600) of Division 3 of, or Part 1 (commencing with Section 10000) of Division 4 of, the Business and Professions Code or is engaged in the trade or business of primarily in person demonstration and sales presentation of consumer products in the home or sales to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis, for resale by the buyer or any other person in the home or otherwise than from a retail or wholesale establishment.

b) Substantially all of the remuneration (whether or not paid in cash) for the services performed by that individual is directly related to sales or other output (including the performance of services) rather than to the number of hours worked by that individual.

c) The services performed by the individual are performed pursuant to a written contract between that individual and the person for whom the services are performed and the contract provides that the individual will not be treated as an employee with respect to those services for state tax purposes.


Employment Development Department agrees with this statement and has stated that it will not assess the employer in the circumstances described in the preceding sentence.  

7. Order of Enactment

It is important to note that C.U.I.C. section 650 was first enacted in 1953 whereas IRC section 3508 was not enacted until 1982. While certainly only speculative, it appears that since the statutes are virtually identical, the federal legislature may have been guided by the California statute. If that is the case, the federal courts should also be guided by the interpretation of the statute regarding the definition of a real estate broker, salesperson, or agent. In doing so, a loan officer could qualify as an independent contractor under IRC section 3508.

8. Conclusions

From the analysis above, there appear to be good reasons, supported by precedent, for the IRS to follow the California definition of the activities of a real estate agent. If the IRS follows this definition, it appears that loan officers working with California mortgage brokers satisfy the elements of IRC section 3508 and could arguably qualify for classification as independent contractors.

The statutory exemption argument under IRC section 3508 appears to have some rather strong legal support. Although Congress, in drafting section 3508, may have intended a rather narrow application of the law, there appears to be justification for a broader interpretation of the regulation. One way to better understand Congress' intent and interpretation of a statute is to look at the proposed regulations for a statute. Although the regulations are not binding they are often times another hurdle arguments must clear.

228. Id.
229. The only difference between CAL. UNEMP. INS. CODE § 650 and I.R.C. § 3508 is the use of the term "real estate broker" or "real estate salesperson" in CAL. UNEMP. INS. CODE § 650, whereas I.R.C. § 3508 uses the term "real estate agent." This difference does not appear to be material.
D.  The Proposed Regulations to Section 3508

Several tax provisions have existing as well as proposed regulations. Although only the existing provisions are binding, it is wise to analyze proposed regulations as well. This analysis is important because the proposed regulations may be adopted at a later date or may provide insight as to legislative interpretation of the existing regulations.\(^{230}\)

Section 3508 was originally passed by Congress in 1982. On January 7, 1986, proposed regulations to section 3508 were published.\(^{231}\) As stated above, it appears the current section 3508 supports the possibility of qualifying loan officers as independent contractors. However, the IRS will argue that the portion of the proposed regulations dealing with services performed as real estate agents does not include the activities of loan officers. Therefore, the IRS will argue it was Congress' intent to treat loan officers as employees.

This argument proposed by the IRS will be evaluated in detail. First, the validity, persuasive power, and deference that should be given to the proposed regulations will be determined. Second, the actual meaning of the proposed regulations will be determined. Finally, conclusions regarding the proposed regulations will be set forth.

1.  Persuasive Power of Proposed Regulations

The proposed regulations were first published on January 7, 1986, four years after the enactment of IRC section 3508, and have yet to be enacted.\(^{232}\) Because the regulations are merely proposed and not adopted, they must be construed as having been published for the limited

\(^{230}\) The proposed regulations may be an attempt to clarify the existing statute. Thus, the proposed regulation may provide insight as to how the legislature interprets the existing regulation.

\(^{231}\) The proposed regulations for I.R.C. § 3508 provide in part:

(2) Services performed as a real estate agent. For purposes of this section, the services performed by an individual as a real estate agent include any activities that customarily are performed in connection with the sale of an interest in real property. Such services include the advertising or showing of real property, the acquisition of a lease to real property, and the recruitment, training, or supervision of other real estate sales person. Such services also include the appraisal activities of a licensed real estate agent in connection with the sale of real property. Services performed as a real estate agent do not include the management of property.


\(^{232}\) Id. The California laws, CAL. UNEMP. INS. CODE § 650 and CAL. BUS. & PROF. CODE § 10132, however, have had full legal effect since 1953 and 1955, respectively. These regulations are binding in their relevant jurisdictions.
purpose of giving the public notice that the regulations are under consideration.233

There are other cases and factors that give one reason to question the persuasive power of the definition of "services performed as a real estate agent" as set forth in the proposed regulations. The proposed regulations were published in 1986.234 To date, they have still not been adopted in final form.235 This delay might indicate that the IRS itself has not determined whether the proposed regulations should be ratified.236

Finally, the proposed regulations were not issued until nearly four years after IRC section 3508 was enacted.237 Regulations not promulgated contemporaneously with or shortly after enactment of a statute should be given less deference because the congressional intent is no longer presumed to have been known.238 Therefore, the proposed regulations should be given less deference than the current version of IRC section 3508 and perhaps less than the definitions in the C.B.P.C.

Hence, although proposed regulations can be useful, the proposed regulations are not binding but merely printed for the limited purpose of putting the public on notice of their consideration. Also, the failure to adopt the provision after several years and the initial delay in the publication of the proposed regulations means the regulations should be given less deference than other proposed regulations and much less than the existing statute.

2. Interpreting the Proposed Regulations

For the sake of argument, even if the proposed regulations were given significant weight or adopted, the proposed regulations would still need

235. Id.
236. Id.; see also Garvey, Inc. v. United States, 1 Cl. Ct. 108, 118-19 (1983), aff’d, 726 F. 2d 1569 (Fed. Cir.), cert. denied, 469 U.S. 823 (1984) (passage of five years from publication of proposed regulations without final adoption could logically give rise to inference that IRS had reason to doubt wisdom of proposals).
to be interpreted. Various rules of statutory construction must be applied to determine the legislature’s intent. Three rules of statutory construction will be applied to the proposed regulations: 1) the plain and ordinary meaning of the words; 2) *expressio unius est exclusio alterius*; and 3) specific exclusion.

### a. Plain and Ordinary Meaning of the Words

As in all cases of statutory interpretation, the starting point for a court in determining Congress’ intent must be the language of the statute itself. A court is to apply the plain meaning of the statute since there is a "strong presumption that Congress expresses its intent through the language it chooses." The proposed regulation states that the services of a real estate agent include "any activities that are customarily associated with the sale of an interest in real property." The plain and ordinary meaning of the word "any" is: "one or more used to indicate an undetermined number or amount." Thus, the legislature must have meant to include an undetermined amount of activities as long as they are customarily associated with the sale of real property. The legislature provided examples of the type of activities they meant to include but according to the plain and ordinary meaning of the word "any," they did not intend to include merely those listed in the proposed regulation. Further, if the criteria is that the activity be "customarily associated with the sale of an interest in real property," it is logical to look to the custom of the location where the activities and sale of the property are taking place. This suggests that one should look to the custom of California. The C.B.P.C. provides a list of those activities customarily associated with the sale of real property, and included in this list are the activities of a loan officer and mortgage broker. Therefore, according to the plain

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239. Fernandez v. Brock, 840 F.2d 622, 632 (9th Cir. 1988); see, e.g., Lewis v. United States, 445 U.S. 55, 60 (1980).
244. CAL. BUS. & PROF. CODE § 10131 provides:

A real estate broker within the meaning of this part is a person who, for compensation or in expectation of a compensation, regardless of the form or time of payment, does or negotiates to do one or more of the following acts for another or others:

(d) Solicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in
and ordinary meaning of the words used in the statute, one must look to
the definition provided in C.B.P.C. and conclude the activities of a loan
officer working with a mortgage broker are included within the scope of
the proposed regulations. Thus, for the reasons set forth above, it
appears the plain and ordinary meaning of the words would include the
activities of a loan officer.

b. Expressio Unius Est Exclusio Alterius

In interpreting the meaning of this proposed regulation the IRS will
argue application of the rule of expressio unius est exclusio alterius:
"the mention of one thing implies the exclusion of another." Application of this rule would result in the inclusion of the activities
stated (showing and advertising of a property, acquisition of lease,
training, and appraisal activities) and the implicit exclusion of the
activities of a mortgage broker and loan officer because those activities
are not expressly stated in the proposed regulation.

Under this principle, the IRS would argue that despite the arguments
set forth above, there is a federal regulation that provides guidance
regarding the activities of a real estate agent and this regulation does not
include the activities of a mortgage broker and loan officer. Thus, the
IRS would argue loan officers working with California mortgage brokers
do not qualify for treatment as independent contractors under IRC
section 3508.

However, federal courts have stated that a discussion of expressio
unius is always necessarily accompanied by a discussion of its limitations. The federal courts have provided several excerpts suggesting
that the rule is perhaps a rule honored more in the breach than in the
observance. One excerpt stated the maxim is not of universal, but
of limited use and application; an aid to construction, not a rule of law;
not conclusive; applicable in limited circumstances; is subject to

connection with loans secured directly or collaterally by liens on real property
or on a business opportunity.

CAL. BUS. & PROF. CODE § 10131 (West 1987).
245. United States v. Castro, 837 F.2d 441, 442 (11th Cir. 1988); 73 AM. JUR. 2D
246. See supra note 231 for proposed regulations.
247. Castro, 837 F.2d at 443 n.2.
248. Id.
exceptions; may not be used to create ambiguity; and requires great caution in its application. 249

The wording of the proposed regulation suggests the expressio unius rule does not apply. The wording does not suggest that the legislators intended the proposed regulation to be an all inclusive express listing of activities. As stated above, the proposed regulation states "any activities customarily performed in connection with the sale of an interest in real property." 250 This is a generally inclusive statement. The proposed regulation continues by giving examples of activities included in the sale of real estate. 251 Moreover, the regulation continues by specifically including appraisal activities and expressly excluding the management of property. 252 If the legislature had intended the examples to be an all inclusive list of activities then they would not have continued by addressing appraisal and management issues specifically.

c. Specific Exclusion

Further, federal courts have held that enumeration of specific exclusions from a statute is an indication that the statute applies to all cases not specifically excluded. 253 The securing of a loan is an activity associated with the sale of a piece of real property and it is not expressly excluded like the management of property. 254 Therefore, it seems the activities of mortgage brokers and loan officers were intended to be included in the statute. 255 This interpretation would qualify loan officers for independent contractor tax status under IRC section 3508.

249. Id.
251. Id.
252. Id.
254. See supra note 231 for proposed regulations.
255. Although not specifically related to the express exclusion rule, the express inclusion of appraisal activities under I.R.C. § 3508 should lead the court to include mortgage brokering activities as well. In order to secure a loan for the refinancing or purchase of a piece of real property, a bank often requires an appraisal. The mortgage broker usually provides the client with a list of reputable appraisers. If the bank has its own appraiser the mortgage broker still usually advises the client regarding the appraisal process. When the appraisal is complete, the mortgage broker then tries to negotiate the best loan for the client based on the appraised value of the property. Therefore, the mortgage broker is involved in the appraisal process. Thus, if the legislature explicitly included appraisal activities within the activities associated with the sale of real property, it is logical that the legislature also intended to include the activities of the mortgage broker who is involved in this process. This interpretation would qualify mortgage brokers for independent contractor tax status under I.R.C. § 3508 (1994).
3. Conclusions Regarding the Proposed Regulations

The persuasive power of the proposed regulations is questionable at best. However, regardless of their persuasive effect, it appears that rules of statutory construction support an interpretation of the term “real estate activities” that includes the activities of a mortgage broker and loan officer.

E. Further Analysis of Section 3508—The Purpose

There are logical arguments favoring the inclusion of the activities of mortgage brokers and loan officers in the activities of real estate agents. However, the IRS has sufficient grounds to make a reasonable argument for their exclusion. When the statutory language gives rise to more than one reasonable interpretation, the court’s duty is to find that interpretation which can most fairly be said to be imbedded in the statute, in the sense of being most harmonious with its scheme and with the general purposes that Congress manifested. As set forth above, there seems to be more than one reasonable interpretation of the activities of a real estate agent. Therefore, one should look to the purpose of IRC section 3508 in determining which interpretation of real estate activities to follow.

The purposes originally behind the statute’s creation were to reduce the number of controversies regarding employment tax status and to improve tax compliance on the part of independent contractors. These purposes would be met because the statute would provide greater certainty and simplification in this area of tax law.

The original and current versions of IRC section 3508 provide three requirements for real estate agents to meet and, if satisfied, the individuals are considered independent contractors or statutory nonemployees. The original version was intended to cover all people who satisfied these elements. The proposed regulation tried to provide greater guidance in regard to the activities of a real estate agent, but, as explained above, this attempt has failed somewhat.

257. Id.
258. Id.
If the courts or the IRS desire to further the purpose of the legislature, a clear explanation of all activities of a real estate agent is required. A clear definition of the activities of a real estate agent is not available from the original statute or the proposed regulations. But a clear definition is available in the C.B.P.C. Therefore, if the courts or the IRS desire to eliminate controversies and further the purpose of the statute, the clear definitions set forth in the C.B.P.C. should be applied. Applying this definition would include the activities of mortgage brokers and loan officers in real estate activities. In doing so, loan officers could qualify for independent contractor classification.

F. Conclusions Regarding Section 3508

In conclusion, loan officers working with California mortgage brokers arguably satisfy the three elements of IRC section 3508. Loan officers are required to be licensed real estate agents, are compensated based on output, and perform services pursuant to a contract that states the individual will not be treated as an employee for federal employment tax purposes.

Although federal law does not provide a definition regarding those activities that are considered to be related to the sale of real property, by applying C.B.P.C. definitions, the activities of a loan officer would be included whether the loan is for the sale of a property or for the purpose of refinancing an existing loan secured by real property.

There are proposed regulations to section 3508 describing the activities to be included. These proposed regulations are not persuasive and are published for a limited purpose. However, after applying rules of statutory construction, it appears the activities of a loan officer are included within the proposed regulations. There are, however, arguments for both sides.

However, in light of the legislative purpose behind section 3508, it seems the IRS should adopt C.B.P.C. section 10131 as the federal definition of real estate activities, at least for California. This clear definition, which includes the activities of loan officers, could reduce the number of controversies regarding real estate agents and their employment tax status. This analysis would also qualify loan officers as independent contractors for tax purposes.

259. CAL. BUS. & PROF. CODE § 10131 (West 1987).
VIII. RECOMMENDATION TO THE IRS

As set forth above, there is a reasonable basis for the argument that loan officers working with California mortgage brokers qualify as independent contractors under IRC section 3508. Therefore, if and when a party raises this argument, the IRS should consider this argument and issue either a Private Letter Ruling or a Revenue Ruling stating whether the IRS adopts or rejects the argument.

An IRS ruling on this statutory exemption argument would provide needed guidance to many mortgage brokers and loan officers. Further, a ruling either adopting or rejecting the statutory exemption argument for mortgage brokers and loan officers would provide for uniformity within the industry. It would also enable greater compliance and fewer controversies. Finally, it would be less expensive than conducting hundreds or thousands of audits of various mortgage brokers. 260

IX. CONCLUSION

In this Comment, the author has attempted to analyze the issue of whether loan officers working with California mortgage brokers qualify as statutory independent contractors under IRC section 3508 for federal employment tax purposes. In attempting this task the importance of independent contractors was considered, as was the seriousness of the issue for mortgage brokers and loan officers in San Diego. Also, the IRS’s common law approach to the issue was evaluated.

There appears to be a logical basis to the argument that loan officers qualify as statutory independent contractors. Therefore, the author urges the IRS to consider this argument if raised by a party and issue a ruling either adopting or rejecting the argument. This is a complex area with little guidance provided by the IRS or the IRC. A ruling would be quite

260. There is a second recommendation: the IRS should refocus their enforcement activities away from misclassification and to the filing and matching of information returns. The filing and matching of information returns would allow the IRS to track and collect revenues due from independent contractors. Compliance can increase through the proper tracking of returns and would not require treating all possible parties as employees. This recommendation was briefly addressed supra part IV. It has been left out of the body of the paper because the topic is one that should actually be addressed in full in another comment. See Hearing, supra note 25, at 85-91.
useful to the many mortgage brokers who are currently targeted for audit
due to their classification of loan officers as independent contractors.

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