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**BY A. PATRICK MUÑOZ**

**Local agencies frequently contract with individuals to teach recreation classes, such as the yoga class shown here.**

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After a routine audit, the Internal Revenue Service (IRS) determined that the City of Dana Point's recreation class instructors were improperly classified as independent contractors and should have been classified as employees for federal employment tax purposes. The city has appealed this decision by filing a petition in the U.S. Tax Court *(City of Dana Point v. Commissioner of Internal Revenue*, U.S. Tax Court Docket No. 3457-10). It appears that the IRS intends to aggressively take this position with other public agencies that provide recreation classes. This article explores the significant ramifications of the IRS's actions and suggests possible strategies.

**Background**

Dana Point is a general-law city located in south Orange County, with a population of approximately 36,000. Like many California municipalities, Dana Point has a limited number of employees and contracts for many of its core services, such as police, fire, animal control and road maintenance. It has 60 full-time employees and about 20 part-time employees.

Each year the city offers approximately 400 recreation classes that cover roughly 70 different topics, including sports, music, cooking, first aid, preschool programs, dog obedience, martial arts and dance. The city contracts with approximately 40 individuals on an as-needed basis to provide instruction for these classes.

Dana Point challenged the IRS over its determination that recreation class instructors should be classified as employees because of the significant impacts that result from the IRS' position. The city's primary concerns are the unacceptable political consequences of nearly doubling its work force by hiring 40 new employees and the cost of treating the individuals in question as employees — estimated at more than $60,000 per year. This cost estimate is based on known factors, such as workers' compensation premiums, payroll taxes and pension contributions, as well as best estimates related to additional staff time for supervision and payroll processing. The estimate does not capture the cost of time spent by "employees" developing their class curriculum or the costs that the city would incur by purchasing supplies and equipment.

Other agencies would face similar impacts if forced to convert independent contractors to employees. Indeed, one city in Southern California that was recently faced with the same issue made a policy decision to simply stop offering recreation classes that could not be covered by existing, limited staffing. This result is obviously not desirable, but perhaps inevitable should the IRS continue to aggressively pursue its position in California. This is particularly disturbing because many residents served by local recreation classes are people who are most in need of low-cost recreational opportunities.

In determining whether an individual should be classified as an employee or an independent contractor, the IRS (and the court, in the event of a legal challenge) looks at the following three main factors.

1. **Behavioral control:** an analysis of the level of instruction the business gives to the worker, such as when and where to do the work. The key consideration is whether the business has retained the right to control the details of the worker's performance or has relinquished that right;
2. **Financial control:** an analysis of the business's right to control financial matters, such as whether the business or worker may make a profit or risk incurring losses; and
3. **The true nature of the parties' relationship:** This is a case-by-case factual analysis. Whether the relationship is truly one of an independent contractor may be evidenced by the existence of a written contract, whether the city provides benefits such as paid vacation and health insurance that would normally be provided to an employee, the permanency of the position and the extent to which the services performed are a key aspect of the regular business of the city.

In addition, the IRS has identified 20 other factors to consider on a case-by-case basis to determine whether a business's control results in an employer-employee relationship or if an independent contractor relationship exists.[1] It's important to note that not all factors must be present to find that an employer-employee relationship exists, nor does any one factor carry more weight than another. Instead, the factors are simply guides to use in assessing whether an individual is an employee or an independent contractor.[2]

The City of Dana Point believes that the following facts, which apply a number of the 20 factors and are nearly uniform throughout the industry, should have resulted in a determination that its recreation class instructors are independent contractors.

1. Each recreation class instructor signs a standard service contract to conduct a specific class. The contract states that the instructor is an independent contractor and not an employee.
2. The city does not require prior approval of the curriculum of the classes and has no right of control over the manner in which the classes are conducted or how the instructors give instruction. Instead, it relies on the instructors for their expertise and to provide both the subject matter and method of instruction.
3. Each instructor determines the number of classes in each session, the length of each class and the minimum and maximum number of students for each class.
4. The city provides no training to the instructors, nor does it require them to follow a set routine.
5. Instructors have the right to — and in fact do — conduct recreation classes for other cities and special districts and, in some cases, directly to the general public.
6. Each instructor is required to hire, train, supervise and pay for substitutes and assistants for his or her classes.
7. Each instructor is required to provide, at his or her expense, materials and supplies needed for his or her classes. Instructors may — and in fact do — use such materials and supplies for classes taught at multiple agencies.
8. Each instructor is paid 70 percent of the revenue generated for each session of classes that he or she conducts and has the opportunity to make a profit (which presumably occurs if classes are popular) or incur a loss if the expense of putting on the class exceeds the share of revenue paid to the instructor.

In accordance with what is referred to as "safe harbor relief" under section 530 of the Revenue Act of 1978, even if the instructors do not qualify as independent contractors they may be treated as such. Agencies may qualify for safe harbor relief to treat recreation class instructors as independent contractors if:

- There is a long-standing industry practice of treating individuals in similar positions as independent contractors;
- The agency has not treated the instructor as an employee in the past;

- All prior federal tax returns have been filed on a basis consistent with treating the worker as an independent contractor; and
- No other worker holding a substantially similar position is treated by the agency as an employee.

Most of these factors are easily met, as Dana Point has always treated its recreation class instructors as independent contractors, has filed all tax forms in a manner consistent with this treatment and treats all people in substantially similar positions as independent contractors. The more work-intensive task facing the city is its effort to demonstrate the existence of a long-standing practice by agencies throughout California of treating instructors as independent contractors. The city has conducted an informal survey that suggests more than 90 percent of cities and other government entities that provide recreation classes to the public do so in a manner quite similar to Dana Point's. As part of its ongoing litigation with the IRS, the city plans to hire an expert witness who will conduct a statewide, statistically valid survey for this purpose. When the survey is complete, the city will make this information available to the League so it may be shared with all interested agencies.

As the Dana Point case proceeds through tax court, it appears that the IRS is moving forward with audits of other agencies and is continuing to take the same position with them related to classification of recreation class instructors as employees. As this occurs, each agency must assess its own unique factual circumstances in deciding how to respond. All agencies will benefit by taking a united approach — to the degree appropriate based on each agency's unique facts — of continuing to challenge the IRS on this issue. Most significantly, this approach will provide the ability for all agencies to continue to assert safe harbor relief under section 530, without regard to whether instructors qualify as independent contractors in the first place.

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**About Legal Notes**

This column is provided as general information and not as legal advice. The law is constantly evolving, and attorneys can and do disagree about what the law requires. Local agencies interested in determining how the law applies in a particular situation should consult their local agency attorneys.

**Footnotes:**

[1] Revenue Ruling 87-41. The so called "twenty factors" are as follows: (1) ***Instructions***. An employee must comply with instructions about when, where and how to work; (2) ***Training***. An employee receives on-going training from, or at the direction of, the employer, whereas independent contractors use their own methods and receive no training from those purchasing their services; (3) ***Integration***. An employee's services are integrated into the business operations because the services are important to the business; (4) ***Services rendered personally***. If the services must be rendered personally, presumably the employer is interested in the methods used to accomplish the work as well as the end results -- an employee often does not have the ability to assign their work to other employees, an independent contractor may assign the work to others; (5) ***Hiring, supervising and paying assistants***. If an employer hires, supervises and pays assistants, the worker is generally categorized as an employee, whereas, independent contractor hire, supervise and pays for their own assistants; (6) ***Continuing relationship***. A continuing relationship between the worker and the employer tends to indicate that an employer-employee relationship exists; (7) ***Set hours of work***. A worker who has set hours of work established by an employer is generally an employee, whereas an independent contractor sets his/her own schedule; (8) ***Full time required***. An employee normally works full time for an employer, whereas an independent contractor is free to work when and for whom he or she chooses; (9) ***Work location.*** If work must be performed on a specified premises, employer control is suggested, whereas an independent contractor may perform work wherever desired so long as the contract requirements are performed; (10) ***Order or sequence set***. A worker who must perform services in the order or sequence set by an employer is generally an employee, whereas an independent contractor may perform work in whatever order or sequence he or she may desire; (11) ***Oral or written reports***. A requirement that the worker submit regular or written reports to the employer indicates a degree of control by the employer consistent with an employer-employee relationship; (12) ***Payments by hour, week or month***. Payments by the hour, week or month generally point to an employer-employee relationship; (13) ***Payment of expenses***. Payment by the employer of the worker's business and/or travel expenses tends to suggest the

worker is an employee; (14) ***Furnishing of tools and materials***. Furnishing tools and materials and other equipment by an employer tends to suggest the worker is an employee; (15) ***Significant investment***. If a worker has a significant investment in the facilities where the worker performs services, this fact suggests the worker is an independent contractor; (16) ***Profit or loss***. Employees are typically paid for their time and labor and have no liability for business expenses, whereas independent contractors can make a profit or suffer a loss; (17) ***Working for more than one firm at a time.***The fact a worker performs services for multiple unrelated firms, entities, or clients, at the same time, tends to demonstrate the worker is an independent contractor; (18) ***Making services available to the general public***. The fact a worker makes his or her services available to the general public on a regular and consistent basis, tends to demonstrate the worker is an independent contractor; (19) ***Right to discharge***. The employer's right to discharge a worker, without facing contractual liability, may indicate the worker is an employee; and, (20) ***Right to terminate***. If the worker can quit work at any time without incurring liability, the worker is generally an employee.

[2] Ibid.

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