Dear [Name]:

This is in reply to your inquiry concerning amounts received by clients of a sheltered workshop. The purpose of this letter is to provide general information to you in writing.

More specifically, your inquiry concerns amounts received by individuals in a sheltered workshop and reported to them on Forms 1099-MISC. You are concerned whether these amounts are earned income for purposes of the earned income credit (EIC). You state that these amounts are received in a work setting. There is no suggestion that the amounts are net earnings from self-employment.

Section 32 of the Internal Revenue Code allows an earned income credit to certain eligible taxpayers. One of the requirements that must be met is that the taxpayer have earned income. Section 32 (c)(2) defines “earned income” as wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.

Generally, wages, salaries, tips, and other employee compensation are received by an employee from an employer. Thus, it is necessary to determine whether an employer-employee relationship exists. Of primary importance is whether the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the results to be accomplished by the work, but also as to the details and means by which the result is accomplished.

In rare circumstances, an employer-employee relationship is deemed not to exist, even though the service recipient has the right to control the individual who performs the
services. Rev. Rul. 65-165, 1965-1 C.B. 446, creates an administrative exclusion from employee status for certain clients of a sheltered workshop. The exclusion is based primarily on the theory that the control exercised by the workshop over those clients is neither the type nor the degree of control exercised by an employer over an employee.

Rev. Rul. 65-165 describes three classes of individuals. The individuals in the first two classes are in the sheltered workshop setting; the individuals in the third class work at home. In the first class, the individuals were given orientation and training as part of a rehabilitation program designed to prepare them for placement in private industry. During the training period, which averaged 16 weeks in length, hours of work were limited by an individual’s capacity to work. However, the purpose of the training was to accustom the individuals to industrial working conditions. The training was accompanied by counseling or other treatment as needed. The individuals received certain monetary allowances during this period, but they were not eligible for benefits that were available to employees of the organization.

In the process of training the individuals in the first class, the organization supervised and directed them in order to rehabilitate and protect them. However, there was no agreement to form an employment relationship, nor was there the degree or kind of direction and control necessary to establish an employer-employee relationship. Accordingly, Rev. Rul. 65-165 held that the individuals in this class were not employees of the organization.

In the second class of individuals described in Rev. Rul. 65-165, individuals who had completed training and who were capable of performing one or more of a variety of jobs offered in the sheltered workshop program performed services in the sheltered workshop program temporarily while awaiting placement in private industry, or permanently if the individual was unable to compete in private industry. For these individuals, the organization provided working conditions and pay scales comparable to those in private industry, fixed working hours, and established production schedules. Individuals were eligible for benefits such as vacations and bonuses. Individuals could be discharged from the program if their work was unsatisfactory. Furthermore, an employment relationship was intended with respect to this group of individuals.

Rev. Rul. 65-165 held that the individuals in the second class were employees of the organization, because the organization exercised a sufficient degree of direction and control over the individuals to establish an employment relationship.

If an individual is an employee, the amounts paid to the employee are generally wages subject to employment taxes. The wages, any income tax withheld, and FICA taxes withheld are reported to the employee on Form W-2.

The term “other employee compensation,” as used in section 32 refers to amounts paid by an employer to an employee that are not specifically designated as wages, salaries,
or tips. Some payments to employees are not defined as wages for any purpose, but they are nevertheless compensation to the employee for his or her services to the employer. These payments include compensation excluded from gross income, such as the rental value of a parsonage and the value of meals and lodging furnished for the convenience of the employer.

If an individual is not an employee, amounts paid to the individual are not wages subject to employment taxes. The amounts are not reported to the individual on Form W-2, but may be required to be reported to the individual on Form 1099. Because the individual is not an employee, the amounts also cannot be “other employee compensation” and thus are not earned income for purposes of section 32.

We hope the above general information is helpful to you. If you have further questions, please call 202-622-6080, not a toll-free call.

Sincerely,

MARK SCHWIMMER
Senior Technician Reviewer (Employee Benefits)
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)